

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.

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.

Now that investors have become convinced that the market is not exactly the perpetual flying money machine dedicated to satisfying all those with sufficient funds to take the trip—as it had been perceived by the end of the ‘nineties—all minds now question as one: *is it over yet?*

The same query was frequently posed to us last year at this time, and we responded with a review of the open interest—the longer term put and call commitments—on index options. At that time we found that call buyers with open positions greatly outnumbered put buyers, especially in the QQQ or Nasdaq 100 options, and we suggested that as long as option buyers remained optimistic in the face of declines (calls are a “bet” in favor of rising prices) we could not really support the idea of a bottom or sustainable rally. Too, the fundamental picture was hardly pretty: tech company revenues were in double-digit revenue decline and the economy was, we were told six months later, in recession. The historic events of 911 induced a kind of selling climax to a market that had already been declining, and the great fear engendered during that period actually did reverse the speculators’ attitudes, prompting a noticeable rally on the heels of the first significant overweighted put buying versus call ownership in years. But soon enough the Pollyannas returned, and once again an excess of optimism combined with a feeble economy to undermine equity pricing. By the end of June the QQQ was down over 25% for the year-to-date, and virtually every major market index is down by double digits.

BUT IS IT OVER YET?

The situation of the market is replete with problems. While we believe there is light at the end of the tunnel and that light is not just another train, it’s important not to shy away from the troubles before us. At the risk of sounding like a financial Yogi Berra, they will pass, but in the meantime they are very much with us.

Perhaps we’re influenced by commencing this writing on the eve of Worldcom’s announcement that it had engaged in 5 quarters and almost \$4 billion of accounting fraud, and we know we’re influenced by the fact that a number of companies we hold have been cast away as a result of revelations of problematic company behavior, but we think that from an investor standpoint the crisis in corporate governance is worse than war.

The relationship of an investor to the company in which he or she invests is like any relationship in life, or at least any relationship that any of us would want to have: it is premised on mutual respect, honesty, and some form of

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“So, everyone who'd like to invest and take a chance that they're about to become a victim of a high-level scam, please raise your hand...”

mutual benefit. Just as a lover trusts his lover with his tender feelings, an investor trusts his company with his vulnerable funds. He does so on the assumption that the company is presenting itself as it truly is, perhaps with some transparent hype or spin, but with reliance on the company's statements of its assets, its earnings, and its prospects—especially when the company makes its statements as federal filings governed by an explicit and extensive set of laws. No investor assumes that company management is actually running a ponzi scheme in which investor capital is converted to executive compensation. Silly investors, who thought they “owned” the company, who thought the company was working *for them!*!

(To be sure, probably the vast majority of corporate managements are straight shooters, but the scale and frequency of corporate fraud and misdeeds at the turn of the millennium do not prompt us to preserve equanimity at the expense of our well-earned outrage).

After 911, investors believed that corporate America was strong and determined, would right itself eventually, and would adapt to new conditions as it always had. So within weeks investors began to buy—and corporate officers and directors were very active buyers of their own companies, it should be noted. An 18-month decline, it was thought, had squeezed the fluff out of stocks and brought them back into the zone of true value for long-term investors. Then came Enron, the first big blow. One of the largest companies in the world, as measured by revenues (we now know were alleged revenues), literally vaporized in a few weeks. Nothing of this magnitude and speed had ever been seen in our country, nor anywhere else that we know of. One after another, the dominoes began to fall as investors, regulators, and newly appointed auditors began to place large, heretofore perceived as impeccable companies, under the microscope. The unregulated energy and utility companies took a pounding. General Electric's accounting was called into question by Bill Gross, perhaps the best bond investor ever (certainly the biggest).

Competitive telecom companies marched single file into bankruptcy court, the consequence of investor manipulation and incompetence by officers and the wirehouse/investment bankers who sold shares in an unsustainable financial structure. Arthur Anderson, the poster-child for a responsible accounting firm, went down in disgrace (and everyone knew that if they were doing it, their colleague firms must be doing it too, or they would be out of business). Merrill Lynch had to settle with the NY State Attorney General on account of its blatant dishonesty with investors regarding its “research” (which was only shilling for its more lucrative investment banking deals). And we know the other brokers are guilty of the same. Indeed, it was the investment banks that first brought the off-balance-sheet limited partnership as a way to hide liabilities to the attention of Enron. It turns out that many CEO's were lying, analysts were tools of stock market manipulation, accountants were toadies, traders were scheming together, and Bill Clinton never had sex with that woman.

So, everyone who'd like to invest and take a chance that they're about to become a victim of a high-level scam, please raise your hand...

That's obviously the biggest problem the market has right now. Rationally, investors surely know that all the houses and cars and blue jeans and tires and nifty electronic gear they buy are real, made and sold by real companies, who make a profit on every transaction (or else, like Reliant Resources, make it up on volume). The companies have jobs that offer paychecks that a bank will cash, they pay pensions, they pay taxes, they have buildings that don't fall down. It's not all made up. Rationally, we know this. But in an arena in which there are so many other, “normal” perils to capital, it has become hard for investors to support the system.

Fortunately, investors have a way of healing over relatively short periods of time (call it attention deficit disorder, call it poor memory, call it what you will, investors do come back to the well). And the regulatory apparatus has a

SELECTED INDICES

	2 ND Qtr'02	12Mo
S&P 500	(13.40)	(17.99)
Equity Inc	(9.99)	(10.65)
Util Fund	(13.38)	(25.19)
DJUA	(9.48)	(20.62)
LB Treas	5.99	9.06
LBGC	3.75	8.25
S&P 400	(9.31)	(4.72)
Value Line	(14.23)	(18.89)
Rus 2000	(8.35)	(8.59)
Rus 2000 Val	(2.12)	8.50

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

way of adapting to the con artists, who always seem to be a half-step ahead of the rules. There is a flurry of activity in many quarters aimed at ring-fencing companies and executives, aimed at severely restricting the movements of people that can only be seen as sociopaths.

Looking at the situation of the broad market here, we find the following:

- 1) The Fed is loose, and is not likely to tighten soon. Historically, this is a positive for stocks. As we noted last quarter, economic improvement, which is also good for stocks, will mean some degree of Fed tightening, which will eventually raise bond interest rates, which is neutral for stocks if moderate - bad if severe.
- 2) Investor confidence in corporate governance is at the lowest point since the 1930's. This is obviously not good for stocks, but if in fact it is at a low point, there may now be nowhere to go but up.
- 3) Quantitative measures of sentiment, such as open interest in calls versus puts on the indices, advisor sentiment, and public/specialist short interest is inadequate to support an intermediate-term rally. This is especially true in the more aggressive areas, such as the Nasdaq 100.
- 4) Short-term options activity supports a short-term rally, as does the fact that both the indices and many if not most individual stocks are severely oversold.
- 5) Valuations support upward price adjustments in some sectors but not all. The "average" stock is still not cheap.
- 6) The dollar has weakened and may well have reversed its long-term upward trend. This is not dispositive, but is definitely unhelpful in terms of foreign flows into our stocks and bonds.
- 7) The macro-environment has changed from peaceful prosperity to a kind of nervous struggle. When the Berlin Wall fell and the USSR collapsed, domestic assets and domestic investors could focus on economic growth. Now political instability is intruding once again.
- 8) By fall, earnings comparisons will be much easier (any signs of life will look good compared to the near-death experience of many companies in the past 24 months), and investors may once again be free to extrapolate limitless growth. There are currently signs of renewed business investment,

a necessary ingredient for economic and stock market growth from here. Indeed, the economic numbers seem to point to recovery, but we think greater confirmation is needed.

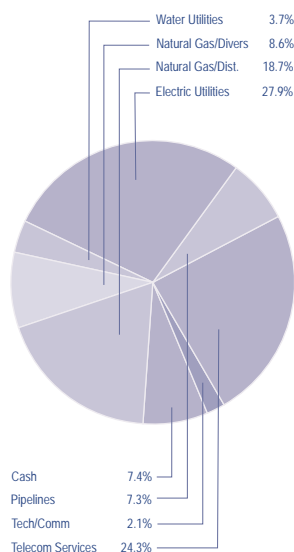
- 9) The old highs reflected a vastly different economic and sentimental framework, and can't be seen as targets in the visible future.
- 10) Corporate insiders have not been buyers of their own company shares. This is in marked contrast to the period just after 911, and has to be included as a negative factor for the six-month outlook (insiders must hold purchases for that long).

The net of these factors is that conditions are reasonable for a shorter-term rally, but a resumption of the persistent stock price growth of the 1990's seems quite unlikely at this point. Over time, we believe that new regulatory efforts born of the recent crises in corporate governance will restore investor faith—just as efforts in the 1930's brought about the institutions we have today that support the financial markets: the Federal Reserve system, the Securities and Exchange Commission, and a variety of self-regulatory organizations. The implementation of this will take time, but in the interim a greatly enhanced level of investor skepticism and rigorous analytic work will likely create an environment in which new laws and government structures tend to certify a new regime rather than create it from scratch. However, periodic shocks from world events and terrorist attacks will put a damper on "exuberance."

Buy-and-hold, the approach that has worked so well in recent decades, may not be the best approach in the several years upcoming. As all those familiar with our work are aware, we have been vocal supporters of deep commitments to situations that make sense. But we're willing to question whether tenacity is going to be the most practical character trait for the next few years, and whether eternal verities may sometimes pause in their power. We recall as a rough model the late 1970's and early 1980's, when the world was also in a less stable phase (Cold War, energy crises, inflation), it paid to be long, but not with an adamant attitude. □

"Fortunately, investors have a way of healing over relatively short periods of time (call it attention deficit disorder, call it poor memory, call it what you will, investors do come back to the well)."

At the end of the first quarter our portfolio had rallied back almost completely from an initial deficit, and we'd thought that "enronitis" was a fading anxiety. We misjudged the depth and breadth of the hidden business behavior and financial reporting problems across the broad market, however, and the degree of problems specific to our sector. No sooner did a calm appear to be developing, than word emerged of Enron's manipulation of the California market, the suggestion (as yet still no more than a suggestion) that other companies were engaged in similar manipulations, revelations of wash trades among a variety of electricity industry participants, and the simple realization that companies were overextended financially in the face of a marketplace characterized by soft commodity prices, shrinking profit spreads, and an excess of competition.



in our worst quarter in the nearly eleven years since inception of this strategy. While there was really no place to hide in any sector this past quarter, we're disappointed that our strategy did not provide at least the relatively safe haven which is its intent, a safe haven provided so many times in the past.

What remains in this area after the bombing? Over the past year we've been way early in our appreciation of the values that have developed across the board in our sector: bearing in mind that caveat, we think that the sound our probe-stick is making is the sound of bedrock. Investors have treated the companies noted above—as well as a raft of others we mercifully don't hold—as if there is no future for energy delivery in America. All eyes are focused on the problems of the present, and while we don't deny there are real problems that need solving, we are also looking at companies with long histories, including histories of solving problems during tough times. When the distractions are as intense as they have been lately, it is all too easy for investors to forget that without pipelines, for example, this country would come to a halt. The basic business proposition remains as intact as it ever was, and is not about to go away.

Will these companies be around to exploit it? We have dug into the current situation of each of them, to form a picture of how they may be viewed in the years ahead, as well as their viability in the current moment. We've also worked with two outside consultants in an effort to determine the answer to the question of the hour: *are they cheap enough yet?*

The answer to this question, we think, lies in determining the value of the companies in the absence of any and all contribution from the assets or activities that have become

Whether instigated by a newfound missionary zeal on the part of the credit rating agencies, by scandal, or by financial stresses—some companies were visited by just one of these spectres, some by all three—a shakeout developed with all the force and shocking speed that has come to characterize financial events in the modern world. As the dust began to settle at the end of the quarter, Aquila had departed the merchant and trading business altogether, Williams, IDACORP, and El Paso had significantly cut their exposure to this area, and NiSource was at least temporarily put out of the game due to the withdrawal of their partner Aquila. All of the companies laid out plans to sell assets and recapitalize their balance sheets, basically to take a step backward before heading forward. And these stocks, with the exception of NiSource, were the key issues that dragged down our performance, resulting

Quarter Composite Net of Fees*

BTB/Util (Preliminary)	(19.80)%
DJUA (total return)*	(9.48)%
LBGC*	3.75%
Ave Util Fund*	(13.38)%

5 Year Composite Net of Fees*

BTB/Util (Preliminary)	4.47%
DJUA (total return)*	7.90%
LBGC*	7.48%
Ave Util Fund*	3.05%

10 Year Composite Net of Fees*

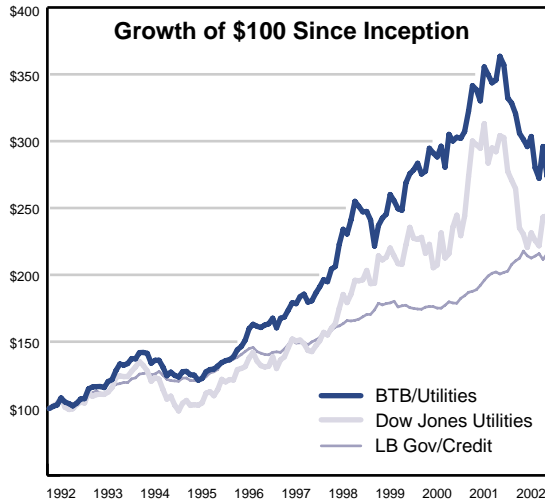
BTB/Util (Preliminary)	8.27%
DJUA (total return)*	7.78%
LBGC*	7.35%
Ave Util Fund*	7.47%

*See Performance Disclosure on page 10.

controversial. (And we do this with some sense of history, as well, since these companies were all successful enterprises long before deregulation, before marketing and trading operations, long before off-balance sheet limited partnerships and wash trades by low-life characters with a mania for fantasy bonuses. In a phrase, these are not dot.coms, and their business is not virtual). When we view the controversial companies in the absence of marketing activities and trading, looking only at hard productive assets and reliable cash flows from regulated business or long-term contracts:

- 1) The average price/book value is less than 1.
- 2) The average price/earnings ratio on this year's earnings is 8.
- 3) The average expected growth rate from this year's new, lower base, is 9.
- 4) The average credit rating is halfway between BBB and BBB+, and all of the companies are engaged in credit-rating improvement programs.
- 5) The average earnings coverage of debt payments is 2.5x.
- 6) The average expected demand growth in the gas industry (these companies are now, at least, primarily exposed to gas demand) is 5 percent.

These numbers add up to much higher potential valuations in the future, once investor confidence in management reporting and operational skills has recovered, and once investors can bring themselves to remember that increased gas usage from a better economy and new gas-fired electric generation will inevitably lead to higher gas prices, which also benefits these companies. We don't know where you can find reasonably solid companies



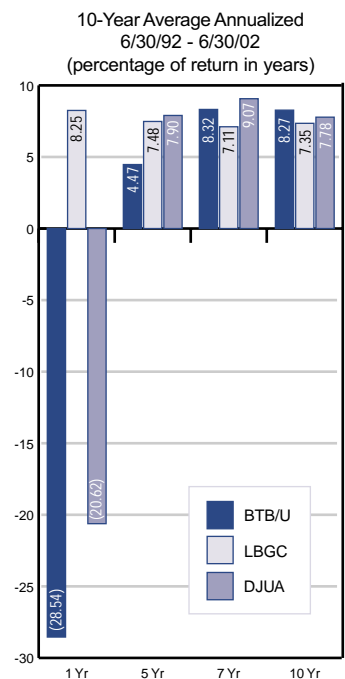
"We don't know where you can find reasonably solid companies this cheap who have such a deep significance to the overall economy. It is a rarity."

this cheap who have such a deep significance to the overall economy. It is a rarity.

By contrast, ten years ago, long before the business digressions in question were present, the valuation numbers were as much as double what they are today: about 2x book, price/earnings ratios in the mid-teens, similar expected growth of 5-8%, similar credit ratings, much lower embedded use of gas in the economy with greater fuel-switching possible in a time of high prices. Bear in mind also that there were numerous pipeline takeovers during the decade of the 1990's, with even weak companies carrying a private market (deal) value of 20 times earnings.

PORTFOLIO HIGHLIGHTS

Indeed, our entire portfolio, impeccable companies and troubled ones together, is at its lowest valuation point in a decade. Though our distribution-only companies have felt just a generalized whiff of the weakness in the equity markets, the Baby Bells, which make up 15% of the portfolio (and nearly 25% if you include non-urban Alltel and Century Tel), have been stuck in the basement as well. We're frankly



“The FERC will be hard put to penalize companies for breaking non-existent laws, and we think a ‘going forward’ mentality will prevail.”

perplexed at the performance here, since the remaining Bells—SBC, Verizon, and BellSouth—have not been cheaper since they were first created, despite the fact that they have persistently demonstrated reliable growth for nearly two decades and their general business position has never been better.

Through a combination of financial strength, political clout, and tenacious if sometimes questionable defensive tactics, the Bells have defeated the new competition that has been permitted in telecommunications. Now, with *de facto* monopolies intact, the Bells are able to sell long distance, wireless, broadband, and enhanced services, to their entrenched wireline base. Capital expenditures can be more measured, and fine-tuned to support earnings in slow economic periods, such as we’ve had recently. These stocks should be at the top of the rankings instead of the bottom, where they languish due to investor fears over the telecom sector in general, fears stimulated by the Worldcoms and Global Crossings of the world, by *other* companies, not the Bells themselves.

The traditional utilities in our portfolio played their traditional role, and many showed positive returns (albeit small ones) for the quarter. Companies like Energy East, DPL, Nicor, AGL, and KeySpan, and newly-added gas distributor Atmos Energy, were all up or flat for the quarter. We did save some ground (avoiding a 25% loss) by selling DQE after listening to their conference call, when it became clear that the dividend was no longer sacrosanct, as it had been in the past. This company is working on what they call a “back to basics” program, ridding itself of a variety of diversification efforts, and may be of interest again once these efforts are shown to bear fruit, as it remains a likely takeover candidate. Here we were able to use our traditional analysis skills and apply our long-standing sell policies, as opposed to reacting to headlines, which was the mode of so many other situations. We would

also add that we’ve been able to entirely avoid the wireless area, site of by far the greatest devastation in the telecommunications area.

LOOKING FORWARD

As George Soros once said, “you can never make back a loss.” Regretfully, we agree with him. All you can do is move forward from where you are now. We think nothing could be more obvious than that our entire sector is moving “back to basics,” from a detour into high rolling that was often ill-reported and disguised from investors—and dependent on high and volatile electricity prices which no longer prevail. Now all are on the alert, from ratings agencies to regulators to boards of directors to investors large and small. The “Perfect Storm” which we described earlier this quarter must be seen as just that, a storm, not a constant and forever state of affairs. What we thought was the back end in March turned out to be the calm of the eye, but that misperception hardly means that storms do not pass. They do.

Here is our scenario: for the month of July, our stocks begin to adjust to the new future. Weak holders that were more interested in growth stories have been giving way to more committed and more value-oriented holders (there is a buy side for each trade in all of the huge volume we’ve seen in recent months). Stocks have an upward bias due to their oversold character, if nothing else.

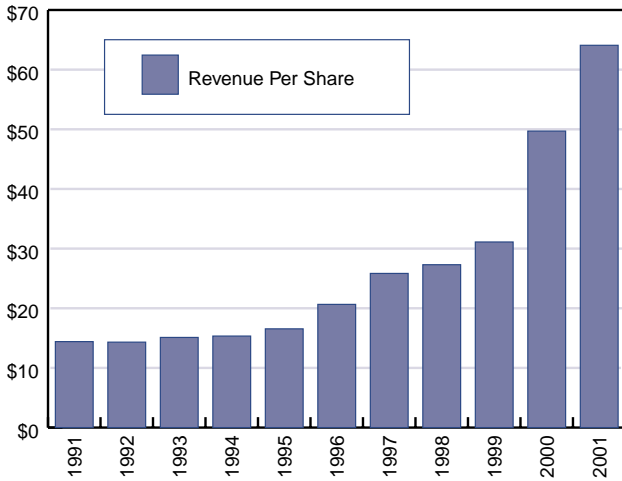
At the end of July the Federal Energy Regulatory Commission has promised a full report on its investigation of the energy trading industry. Will more bombshells drop? Our guess is that most of the uglier revelations are out in the open now, though that’s just a guess. What we’re sure of is that the structures and rules governing the markets will be criticized—and the FERC will likely criticize itself, along the lines of a recent critique by the General

UTILITIES PORTFOLIO CHARACTERISTICS

Beta*	0.51
Dividend Payout	45.51%
Sharpe Ratio	0.29
Proj Dividend Growth	3.61%
Treynor Ratio*	6.97
Current Yield	4.37%
Annualized STD	12.31
Market Cap (MDN)	\$3.5 Bil
Price/Book	1.80
Quality (Equity Rating)	A
P/E Ratio	12.39

*Relative to S&P500, 6/30/92-6/30/02

Revenue Per Share



These charts illustrate historical valuations, revenue per share, and yields for our Better Than Bonds/Utilities portfolio.

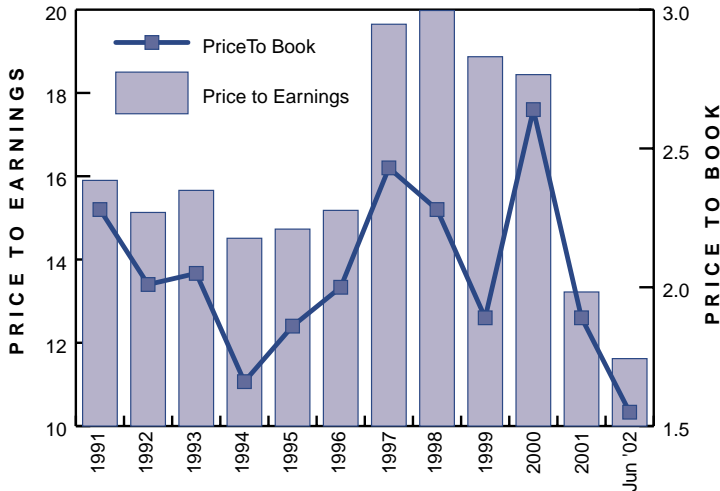
What we see in the charts are a group of companies that has steadily grown in business and yet valuations have declined to historically low levels.

Included are all current holdings excluding telecom and water utilities (American Water Works). We excluded telecoms due to their generally higher P/E and book value relationships. However, telecoms are at comparable low valuations as well. We will be putting a similar set of graphs for telecoms on our website (www.mhinvest.com).

The companies included are:

- | | |
|----------------------|---------------|
| ATG Resources | Atmos Energy |
| KeySpan Corp | NICOR Inc. |
| Peoples Energy | El Paso Corp. |
| Kinder Morgan Energy | Questar Corp |
| Williams Co | AES Corp |
| DPL Inc. | NiSource Inc. |
| Allegheny Energy | Energy East |
| TECO Energy | IDACORP Inc. |
| MDU Resources | |

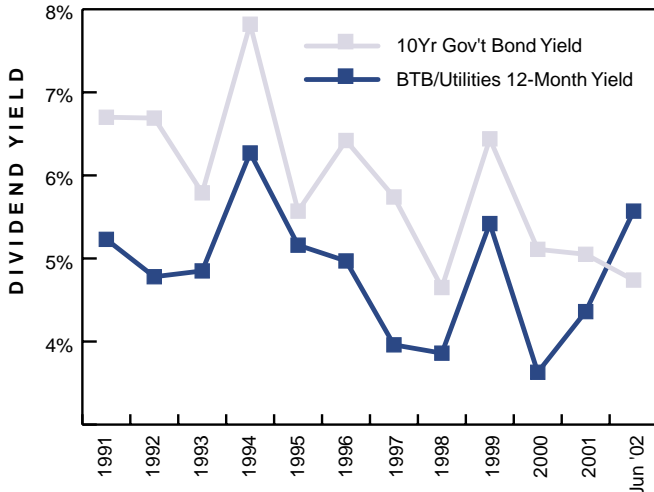
Historical Valuations



Historical 5-Year EPS Growth: 9.63%
 Projected EPS Growth: 7.89%

Historical 5-Year Dividend Growth: 4.3%
 Projected Dividend Growth: 3.4%

Historical Dividend Yields



Typically, current yield is lower than the 10-year bond. Today it is higher, showing again, an historical valuation discount.

Data Source: All historical data from Bloomberg LP. Numbers for the Better Than Bonds/Utilities portfolio are a simple average of annual numbers.

Accounting office which took the FERC to task for its general laxness. The first reaction to California's crisis was that it was caused by a woefully inadequate system put in place by the legislature, and despite a year's intense political posturing by Governor Gray Davis and anyone else who may be held responsible, the fact remains that as far as is known rules and laws weren't actually broken. They simply weren't there in the first place. The FERC will be hard put to penalize companies for breaking non-existent laws, and we think a "going forward" mentality will prevail.

Meanwhile, the Congressional conference committee has once again taken up consideration of comprehensive energy bills passed by the House and Senate. There remains much to be worked out, but with regard to the repeal of the Public Utility Holding Company Act all parties appear to be in agreement. We've been waiting and waiting for this, since passage will inspire considerable merger activity in the sector, we think. Drilling in Alaska remains the sticking point...we'll simply have to await the outcome.

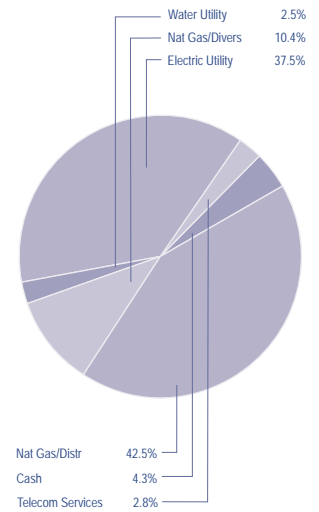
But there remain many stocks which can be freely taken over without the repeal of PUCHA, and there are many buyers waiting in the wings: the major German and British utilities, Warren Buffet, several private equity buyers, and several domestic utilities have all publicly expressed interest in consolidating the US industry. In the past, the generating and pipeline companies were too expensive to look at, and consolidation activity took place primarily among the more secure distribution companies. But now there are also lots of cheap production assets to be had in one swoop by buyers who have the necessary deep pockets. What we really think will break the fever here is the first big takeover transaction. A new regime of rules and some positive headline news in the form of a takeover at a premium are the key milestones. □

Though the Distribution/Emerging Utilities strategy was a more moderate place to be than utilities generally and certainly than the broader market, the negativity prevalent for equities during the second quarter finally proved too great a drag. And we were touched by a few of the "headline" stocks to which we'd hitherto been immune.

PORTFOLIO HIGHLIGHTS

On the positive side, local gas distributors provided supportive returns, ranging from over 10% for a rebuilding NUI to 3% for what has become an increasingly consistent KeySpan. There was a bundle of stocks in the electricity area with single digit losses. And then there were our "headliners." These latter are particularly difficult to cope with, for price changes accompany headlines in a flash, typically before the open, and there's no real chance to defend the portfolio. Then comes the evaluation of the credibility and the ultimate significance of the news, and by the time a rational analysis can be reached the markdowns have been all but concluded.

Last winter we added Williams when we thought it had reached a price at which various parties could be interested in it as a takeover. Subsequent purchases by Warren Buffet and presentations by the company regarding its future course increased our comfort level. Then the New York Times ran a piece extensively quoting a disgruntled former employee who claimed that Williams traders had tried to corner the gas market in California. The article was unbalanced, calculated to disrupt, and made no attempt to present the company's response, although the company had, indeed, responded



Quarter Composite Net of Fees*

Distribution (Preliminary) (8.63)%
DJUA (total return)* (9.48)%

12 Month Composite Net of Fees*

Distribution (Preliminary) (6.73)%
DJUA (total return)* (20.62)%

3 Year Composite Net of Fees*

Distribution (Preliminary) 10.20%
DJUA (total return)* (1.06)%

*See Performance Disclosure on page 10.

“Where else today do you find 4+% yield, exceptional stability, plus appreciation potential (as a result of M&A activity) as great in the near and intermediate terms as any sector of the market?”

FUNDAMENTAL CHARACTERISTICS	
Yield	4.58%
Proj Div Gro	3.03%
Payout Ratio	57.43%
Market Cap (MDN)	\$2.0 Bil
Price/Book	1.62
P/E Ratio	13.19
Quality (Equity Rating)	A
Beta*	0.23

*Relative to S&P 500, 6/30/99-6/30/02

to each point in the article prior to publication. “Investors” had no need to wait for the truth, and sold the stock down more than 30% in two days. Management of such situations becomes quite problematic, but we follow the Williams evolution carefully and we know Williams is a survivor, and at current prices the company is more attractive than ever as an asset play. We had small positions in Aquila and CMS Energy, which were also hit by headlines. Aquila, in an effort to maintain and improve its credit position, abandoned its trading operation entirely. For the kind of distribution acquirer we have in mind, this actually makes the company more attractive, not less so, but growth-driven investors took this as the exit signal, even though their selling has driven the stock to 5-6 times this year’s earnings (as recently confirmed by the company). CMS, on the other hand, turned out to be an accomplice of Reliant Resources in creating “wash trades” that did not impact the earnings statement but nevertheless provoked an unpleasant twitch in one’s nose—and caused heads to roll in the executive suite. Here too, trading is gone, leaving a distribution franchise (and a few other moving parts which will be sold off) that actually better fits our model for a potential acquisition. We prefer to hold impeccable and strong companies that are also acquisition candidates (so that in the absence of a deal we still hold a reasonable and productive investment), but in these cases both the reduced prices and the move toward more completely traditional operations makes the stocks of continuing interest to this portfolio—at their newly reduced weights. The news flow has begun to diminish, but with the “headline” stocks our interest in their low valuations is tempered by an alertness born of recent lessons that almost any unimaginable thing can happen to a company in today’s world.

LOOKING FORWARD

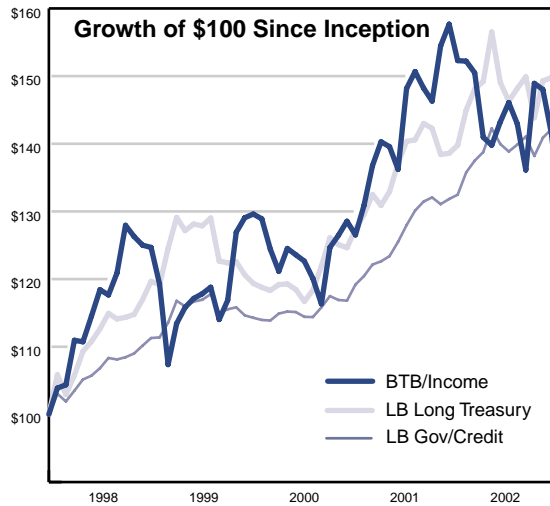
Mercifully, nearly all the other companies in our portfolio are local monopoly, non-diversified, plain vanilla, your father’s buick, traditional utilities: 50% debt, 50% equity, close regulator supervision, “guaranteed” rate of return on equity, pass-through for unanticipated risks...etc. These, and integrated electrics (local generation plus distribution), continue to be the primary figures in our portfolio. We have encountered numerous public statements in the past three or four months from foreign utilities, domestic utilities, energy companies, and financial buyers, all expressing keen and current interest in consolidating the US utility industry. We think a second wave, equal in force to the first wave of 1998-2000, is building. Foreign acquirers, in particular, have been busy in the past couple of years acquiring other companies in Euroland, but they still have deep pockets and there is little left to buy overseas. Repeal of the Public Utility Holding Company Act has never been closer—this summer the reconciliation process between House and Senate energy bills is under way—and, whether outside of repeal or as a result of it, we believe the dry spell in takeovers will begin to lift in the second half of this year. Given the market environment our returns have been quite acceptable in the absence of recent deals, but the high potential here remains palpable. Where else today do you find 4+% yield, exceptional stability, plus appreciation potential (as a result of M&A activity) as great in the near and intermediate terms as any sector of the market? □

We may have beaten the S&P 500 this quarter, but we're not in any mood to cheer. Despite solid performance from our real estate and bank positions, the portfolio's exposure to an ailing utilities sector left us with some painful – and hopefully passing – lumps. Read our BTB/Utilities piece to get a more in-depth explanation of why utilities are still having such a tough time. Between dividend increases and moderately depressed prices, we saw our portfolio yield climb to 7.3%.

PORTFOLIO HIGHLIGHTS

Banks were excellent performers this quarter, particularly relative to the steep downturn experienced in the broader market. Offering attractive yields, conservative valuations, and the promise of accelerated growth in the event of an economic recovery, Amsouth, KeyCorp, Union Planters, and US Bancorp all posted moderate gains. Furthermore, most of these companies remain attractive takeover candidates, which is one of our criteria for owning banks. The long-running consolidation in banking is hardly over. This sector has clearly found favor with the market recently, in part, due to the perception that small and mid-sized banks are strictly regulated and utilize conservative accounting practices . . . and conservative accounting coupled with steady dividend growth has assertively taken center stage.

Our real estate investment trusts held their own this quarter, which is no small feat considering the behavior of the broad market. Among the bright spots, we sold Colonial Properties for a gain of 18% when it began to trade above its historical premium to Net Asset Value. Colonial develops, manages and leases multifamily communities, office buildings, retail malls and



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shopping centers in the Sunbelt region of the United States. We swapped Colonial for another REIT operating in the southeast, Cousins Properties, that we found trading at a discount to its typical premium to NAV. Historically, Cousins has traded as high as 30% above its NAV, whereas our entry point represents an 8% discount to NAV. Having increased its NAV by 47% since 1998, Cousins looks to have great potential for the coming quarters.

We're considering swapping out additional REITs, looking for a margin of safety in NAV discounts. Our United Dominion Realty looks highly promising since it increased its NAV by a whopping 11% in April. Whether we add some UDR or find others, we're going to be very cautious, and selective in adding any new position to the REIT segment of our portfolio. We're mindful of the long, steady gains REITs have enjoyed in recent years, and want to be sure we're still buying value (i.e. discount to NAV) to limit downside risk.

Notably, Enerplus, a veteran portfolio holding that operates a Canadian energy trust was one of our best performers this quarter, gaining nearly 13%. There were also a raft of dividend increases by portfolio utilities this

Quarter Composite Net of Fees*	
BTB/Income (Prelim)	(12.38)%
LBGC	3.75%
LB Long Treasury Index	5.99%

12 Mo Composite Net of Fees*	
BTB/Income (Prelim)	(14.31)%
LBGC	8.25%
LB Long Treasury Index	9.06%

5 Year Composite Net of Fees*	
BTB/Income (Prelim)	5.46%
LBGC	7.48%
LB Long Treasury Index	8.80%

*See Performance Disclosure on page 10.

quarter, including TECO Energy, Suburban Propane Partners, Kinder Morgan Energy Partners, and dividend increases for the *second time this year* by El Paso Energy Partners and Allied Capital. Indeed, as of this writing, Allied Capital committed itself to a 10% dividend increase for 2002.

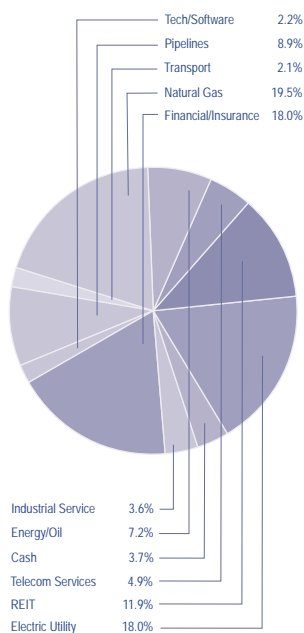
Having added Worthington Industries late in the quarter, we're pleased to report that it's already pulling its weight, up over 15%. Worthington is one of the country's most respected value-added steel processing companies, boasting an unbroken history of dividend growth stretching back 17 years. At our entry point, Worthington offered a yield of over 4%, and was characterized by a low PE, low price-to-book ratio, little debt, and high credit quality. In their fourth consecutive quarter of earnings growth, Worthington reported an 85% year-over-year jump in earnings on increased demand for their core, processed steel products, accompanied by dramatically increased quarterly revenues. We have high hopes for this industry leader.

Notable on the downside was Amdocs preferred, which we dumped – thankfully – the day before they lowered their earnings estimates for the year. The writing was on the wall for this provider of telecommunications software and billing services, and Amdocs finally fell prey to the slump in telecom spending. By selling when we did, we *avoided* losing an additional 50% in market value.

LOOKING FORWARD

With the utilities segment of this portfolio having been beaten into submission, and trading at unprecedently cheap valuations, we look for utilities to begin pulling some of their weight in the short- to intermediate-term. Whether the catalyst for the utility sector's resuscitation is driven by weather, macro-economic

improvement, firming of commodity prices, or acquisition by foreign utilities. . . these vital companies cannot stay depressed indefinitely. Generally, we're pleased to see that pundits and investors both are once again seeing the value of real companies with real dividends, real *cash* dividends, as true investment positions. Our portfolio values are good, and this new constituency augurs well for us, as yield-oriented equities are increasingly scarce as a result of the previous investor attitudes in the 1990s. And a strong current yield combined with dividend growth has always been the core of this portfolio's strategy. □



FUNDAMENTAL CHARACTERISTICS

Yield	7.33%
Proj Div Gro	4.81%
Payout Ratio	57.57%
Market Cap (MDN)	\$2.8 Bil
Price/Book	1.98
Beta*	0.50
P/E Ratio**(MDN)	11.85
Quality (Equity Rating)	BBB+

*Relative to S&P 500, 6/30/97-6/30/02

**REITs use P/FFO ratio rather than P/E Ratio

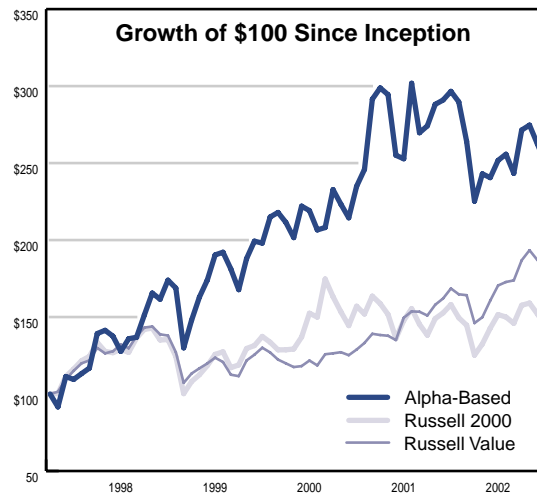
Disclosure

Yield-Oriented Portfolios: 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. Returns are total returns with dividends assumed to be reinvested. 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 6/30/02 was 296, which represents 95% of total assets managed in this strategy with a measure of dispersion of 0.50. 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 6/30/02 was 30, which represents 83% of total assets managed in this strategy with a measure of dispersion of .33. Inception of the Distribution composite was January of 1999. **Better Than Bonds/Income:** Composite includes 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 6/30/02 was 114, which represents 66% of total assets managed in this strategy with a measure of dispersion of 0.34. Inception of the composite was June of 1997.

The Alpha-Based Strategy was able to withstand the winds of insecurity in the broad markets, gaining 0.86% for the first half (gross of fees), during a severe downturn which seemed to have consumed practically every sector of the economy. For the quarter, we also outperformed the Russell 2000 index as it ran into major resistance in mid-May, “catching down” to the rest of the market.

PORTFOLIO HIGHLIGHTS

As of this writing the portfolio emphasizes medical services/supply companies and smaller pharmaceuticals. Each stock gives the portfolio its own set of uniquely attractive valuations, the combined weight at the moment is in the neighborhood of 35%. This group is extremely interesting, in our view, as most of our holdings trade at very low PEG ratios, are fairly independent of the overall economy, have tremendous insider ownership accompanied by persistent buying and are prime takeover candidates in the area. In fact, our Boron, LePore was recently bought by Cardinal Health this quarter, resulting in a 45% gain for our portfolio. A new name in the portfolio is Cardiac Science (DFIB), a manufacturer of automatic external defibrillators used to treat patients at risk of sudden cardiac arrest. With a solid balance sheet and a strong pipeline of products that are now required in most public spaces, including airports and schools, and increased spending on defibrillators generally, this stock should look extremely attractive to larger players in the field. But while we’re waiting, DFIB has strong projected earnings growth and is a new addition to Russell 2000 index, which creates a new set of constituent buyers.



Other additions include PPDI, Pharmaceutical Product Development, a company that provides a range of R&D and consulting services to the pharmaceutical and biotech industries, Medtox Scientific (TOX), a developer of lab toxicology testing devices, and Curative Health (CURE) primarily focused on the chronic wound care market.

Retail & consumer non-cyclicals carry high weight in our current allocation, totaling approximately 20% of the portfolio. Playtex, up 8% since our purchase, is trading at 13x next year’s earnings with projected EPS growth of at least 10%, and an 18-40% discount on a P/E basis relative to its peers. In our opinion, debt reduction should be one of the earnings drivers near-term. Over the longer-term horizon, we wouldn’t be surprised to see PYX become a consolidation target. It’s no secret that the company’s two largest shareholders (combined owners of 52% of the shares) are currently seeking an exit plan. Naturally, the obvious options here might include a merger, a secondary offering or a sale of separate business segments. Management of the company has previously

“Going forward, we’ll stay alert to any signals of deteriorating fundamentals and risk/reward profiles of our holdings while at the same time searching for value and taking gains as they come to us.”

Quarter Composite Net of Fees*

Alpha-Based (Prelim)	(7.85)%
Russell 2000 Value	(2.12)%
Russell 2000	(8.35)%

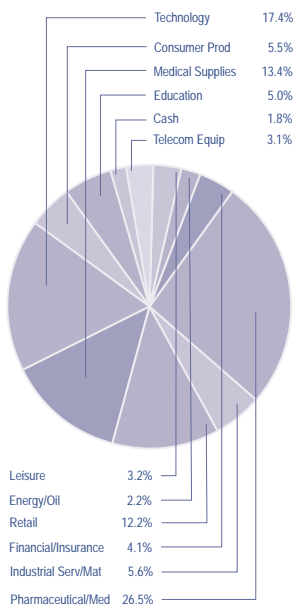
12 Month Composite Net of Fees*

Alpha-Based (Prelim)	(15.69)%
Russell 2000 Value	8.50%
Russell 2000	(8.59)%

5 Year Composite Net of Fees*

Alpha-Based (Prelim)	17.95%
Russell 2000 Value	9.71%
Russell 2000	4.45%

*See Disclosure on page 12



indicated that a secondary offering would happen only if it was neutral to earnings, which would place the stock at \$18, according to the street consensus. We also like the consistency and commitment of PYX management and are happy to hold the stock even in the absence of an immediate buyout.

Other retail holdings, including Friedman’s up 21% for the quarter, School Supplies down fractionally, Total Entertainment (retail/restaurant) up 16%, and Helen of Troy down 18%, make up the balance of the sector. At the end of May we finally broke down and added Charming Shoppes to our list (CHRS). Our interest in “plus-size” plays has grown with time, as we’ve observed the successful integration of Lane Bryant into the portfolio of CHRS. This year the plus-size business is expected to eventually account for 85% of sales, up from 72% last year. We like the theme here—let’s face it, Americans aren’t getting any thinner—and though we would have preferred more of a bargain price the premium is well deserved and will be recognized by the investor community as Charming continues to report accelerating growth.

We did a bit of fancy dancing during the quarter, taking substantial profits in both Take-Two and Headwaters and then buying both back at lower prices prior to a bounceback. Take-Two continues to rule the top of the software gaming charts, and Headwaters has recently signed a deal with China’s largest coal company to create the first commercial coal liquefaction plant. We think the area of coal liquefaction could be an enormous developing industry, and with this deal HDWR moves ahead of the competition, which only has demo plants running. Although they’re smaller than the competition, their technology appears to be superior.

On the sell side, in addition to taking timely profits in Headwaters (realizing 90+%), we sold Shaw Group (gain of 18%), Keith Companies

(gain of 45%), Century Business (gain of 40+%), and trimmed some of our heavy weights at the intermediate top. We were also fortunate to soften the blow of major torpedoes that touched our stocks by exiting Seitel shortly before the management allegedly “misappropriated funds,” and by selling GNSS, Eclipsys and a small position in Rambus before disaster struck these companies.

LOOKING FORWARD

Going forward, we’ll stay alert to any signals of deteriorating fundamentals and risk/reward profiles of our holdings while at the same time searching for value and taking gains as they come to us. The investment team continues to research ways to make our strategy increasingly efficient, and so far this year, anyway, those efforts appear to have born fruit. The world has become an uneasy place for investors, but in the end strong values will find buyers, and our valuations provide us with a measure of safety that makes recent fluctuations far easier to tolerate. □

Disclosure: Net of fees performance is based on actual results after the deduction of management fees (weighted average fee of 200 basis points). Returns are total returns with dividends assumed to be reinvested. 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 6/30/02 was 62, which represent 90% of total assets managed in this strategy with a measure of dispersion of 0.36. Miller/Howard Investments has prepared all performance results. Inception of the composite was 3/31/97. Some accounts were in a modified version of the strategy; they became part of the composite October 2001. Portfolio was managed by William T. Chidester from inception through November 2000. Team managed since December 2000.

FUNDAMENTAL CHARACTERISTICS

Forward P/E Ratio	16.00
Forward PEG Ratio	0.68
Market Cap (MDN)	\$265 Mil
Price/Book	2.18
LT Growth Rate	23.4
Beta*	1.00
R-SQR*	0.40
Annualized STD	28.22
Alpha*	16.56

*Relative to S&P500, 6/30/97-6/30/02