

MARKET OVERVIEW

THE STRATEGIES

INCOME-EQUITY STRATEGY

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

RISING DIVIDEND PLUS

A large-cap value strategy comprised primarily of established and seasoned companies with high financial strength that are likely to provide steadily rising earnings and dividends.

BETTER THAN BONDS / UTILITIES

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

DISTRIBUTION / MERGING UTILITIES

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

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The macro environment is two-faced, bifurcated, something like the moon with a bright side and dark side, generating tides that pull equity investors in, then push them away. And like all things governed by the moon, investors are emotional, uncertain and fragile.

The bright side is the laudable performance of the U.S. economy over the past five years. It has proven a tough and resilient dynamic system, never more so than when one contemplates the challenges it has had to overcome. A partial laundry list would include: the collapse of the technology bubble, major corporate governance and fraud scandals (Enron et al), the World Trade Center bombing, war in Afghanistan, war in Iraq, a dubious election, loss of credibility in the administration, historic low approval ratings for the Presidency, a tip-toe to the edge of deflation, substantial loss of manufacturing and outsourced service business to developing nations, the decline and fall of US auto manufacturing, natural disasters culminating in the loss of a major city, skyrocketing energy costs, and the spooky spectre of 1% Fed Funds rates accompanying a 30% loss in the value of the dollar. What a champ the US economy must be, that it can take these punches and still produce record-breaking profits for corporations (albeit on the backs of workers who are seeing much less of the benefits).

But more challenges (and challengers) await, and these have been widely adumbrated: the risk that an inevitable cooling period will devolve into something worse. The risks to the dollar of possible foreign reluctance to continue buying US government securities. Geopolitical risks ranging from Iraq to Iran to North Korea, and various energy-crunch scenarios not yet imagined. Looming financial problems with Social Security and Medicare. Accidents in the now-gargantuan derivatives markets. The dollar under siege. Global warming. You name it; there are ample reasons for investors to bet two dollars instead of two hundred.

Call us crazy, but we're more comfortable now with the situation for stocks than we were. To be sure, the concerns that cast a shadow on the landscape may limit the upside (the willingness of investors to embrace a longer-term prosperity)—and stocks could easily be as frustrating yet decently supported

as they were in the excruciating January-March period, but the long-side odds have improved. Trotting out our previous ten-point program, we find the following:

“But we’ve caught enough straws in the wind to make a basket here, and, possible summer doldrums aside, well-selected stocks should not be too constrained under current conditions.”

- 1) At the end of last year the consensus of “watchers” believed *the Fed* had one or two rate increases left. Well, they still hold that view, though there have already been four increases in 2006. We have no clue about when the Fed will stop (and we doubt the governors really know either). It will be “data-dependent,” they’ve said—as if there’s anything under the sky that isn’t. Our “dumb rule of thumb” regarding interest rates has served us well over the years, limiting our incorrect view to one time per cycle: *whatever direction rates moved in most recently will be the direction they move in next.*
- 2) Global politics continue to be a factor that will contribute to be a “ceiling” on prices. No runaway bulls when terrorists and belligerent states are loose in the world.
- 3) *Traditional sentiment measures* have become much more favorable. Recent declines have pinched some closet bears in the rear and now they’re out in the open, flailing their warnings (as if no one else was aware of potential pitfalls). As of this writing there were more bearish newsletters than bullish, a rarity! The advance-decline line did take a knock during the market correction, but it began to hold fast long before prices did, and “looks” to be bottoming. There are talking bear-heads all over the media. The ratio of public short sales to specialist short sales is at a five year high.
- 4) Our *proprietary sentiment indicator*, measuring open interest in index puts and calls, has recently become surprisingly positive. Late June market strength was met with a wave of committed put buying, of skepticism and fear, especially in the Nasdaq 100 products. It’s the first notable change this year, substantially reinforcing our ongoing notion that this indicator suggests any declines will be modest. Beyond that, it looks like large growth may take a turn in the lead (though we’re not paying too much attention since those are out of our field of vision).
- 5) *Valuations* remain untroubling.
- 6) *The dollar* now competes with, basically, the Euro, the Yen and gold. We suspect that gold is the new dollar, and that dollar weakness relative to the Euro has probably run its course, since U.S. growth is better than Euroland and U.S interest rates are higher.
- 7) *Mutual fund cash flows* aren’t supportive, and, indeed, the arrival of ETFs in the marketplace has muddied the potential meaning of this factor. Times change. It probably doesn’t count any more.
- 8) *Earnings* still have not stumbled, and continue to defeat pessimistic or even moderate pundits. Too, there is so much corporate cash with which companies may now shrink their capitalizations through buybacks and thus support earnings that we think it’s reasonable to assume that earnings will continue to surprise on the upside. We adjust our expectations for an assumed slowing this summer.
- 9) *Hidden taxes* persist. State-mandated minimum wage increases, health cost increases, energy price persistence, property tax increases—all these conspire to slow the economy below potential. Now, with debt high and savings low, we can add interest rate increases to the rising cost mix.

SELECTED INDICES

	2 nd Qtr’06	12 Mo
S&P 500	(1.4)	8.6
Equity Inc	(0.5)	9.1
Util Fund	3.9	11.0
R3UTIL	4.1	9.8
LB Long	(1.2)	(6.3)
LBGC	(0.1)	(1.5)
R1000	(1.7)	9.1
Wilshire 5K	(1.9)	10.0

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

10) *Insiders* have changed their tune over the course of this year. From the pits in the later half of 2005, net insider activity is now bullish by any measure we know of, and scores better than June 2005. *Insiders* aren't always right, but aggregate highs and lows of insider activity have been fairly good intermediate-term indicators.

We continue to think, as we have for longer than we care to remember, that there will be plenty of friction hindering stocks from making substantial new highs. But we've caught enough straws in the wind to make a basket here, and, possible summer doldrums aside, well-selected stocks should not be too constrained under current conditions. □

2006 PERFORMANCE

	2 nd Qtr '06	YTD
Miller/Howard Investments (net of fees)		
Income-Equity	2.9%	8.9%
Rising Dividend Plus	3.2	8.7
BTB/Utilities	1.7	5.8
Distribution/Merging Utilities	4.9	7.9
Indices		
S&P 500	(1.4)%	2.7%
Russell 1000	(1.7)	2.8
Russell 1000 Value	0.59	6.6
Russell 1000 Growth	(3.9)	(0.9)
Russell Midcap	(2.6)	4.8
Russell Midcap Value	(0.6)	7.0
Russell Midcap Growth	(4.7)	2.6
Russell 3000 Utilities	4.1	10.4
S&P Utilities	5.7	4.5
Lehman Long Treasury	(1.2)	(4.8)
Lehman Gov/Credit	(0.1)	(1.2)

Annual ADV Update

Under Securities and Exchange Commission regulations, we are required to offer you, annually, a copy of our latest Form ADV, Part II. If you would like a copy of our ADV, please contact Marilyn at:

(845) 679-9166

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

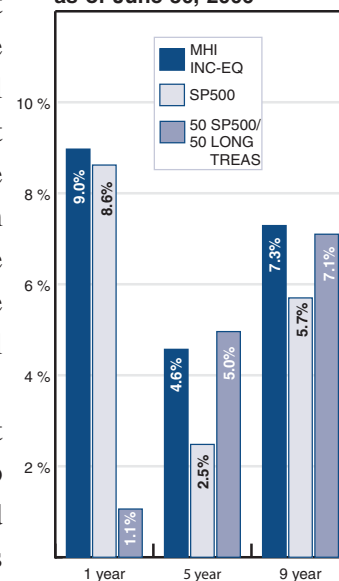
Last quarter we suggested that our “team” of stocks didn't look to us like it needed much in the way of freshening up, and that the quarter would be all about individual stock picks—with little help from the indices going forward. That was just about right, as every standard index category from broad-based to style-based was negative for the quarter, but the oars on our “team” kept rowing, providing healthy positive returns. Since our goal is to own stocks that are easy to hold when times are tough, the quarter provided positive reinforcement.

Not only did stocks start to gyrate, but long-term bonds were a notably miserable place for investors to be. This is of special interest to us, since long-term bonds are just about the only investment that can compete with our level of income. Long-term treasuries were down about 5% for the year to date, giving us a gross advantage of over 1400 basis points, or 14 full percentage points.

For many quarters we've pointed out that the Income-Equity Strategy is not tied to interest rates, though news reporters and even not-so-naïve Wall Street strategists seem to think that high-yielding stocks are sensitive to rates. We're not suggesting that sharply rising rates aren't a negative for our stocks as well as all stocks, but last quarter we pointed out that an evaluation of “duration” for equities indicates that lower-yielding stocks should, in theory at least, be more sensitive to rates than higher yielding stocks. These kinds of analyses are always more difficult when abstract—so it's nice to have a very overt concrete case right in front of us adding sharpness to the point.

“Since our goal is to own stocks that are easy to hold when times are tough, the quarter provided positive reinforcement.”

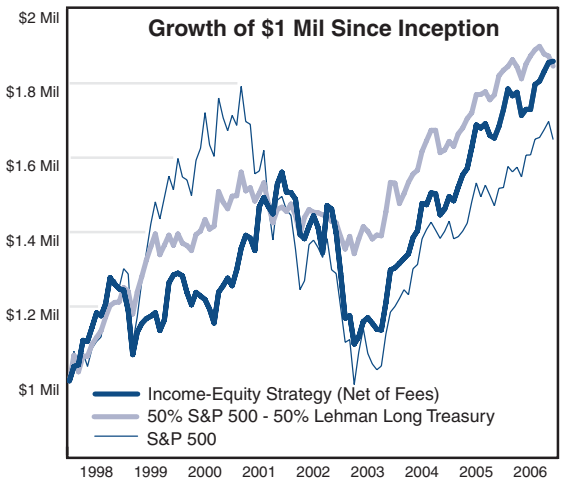
Annualized Net of Fee Returns as of June 30, 2006



"...happy because we're small, centralized, and agile enough to act quickly and first when Mr. Market is in the mood to hand out gifts."

PORTFOLIO HIGHLIGHTS

When natural gas prices and natural gas stocks tumbled as a result of reduced demand generated by the warmest winter in 112 years, we began sniffing about for a stock more affected by product prices than volumes (we already hold many pipeline and distribution stocks whose business is volume sensitive rather than price sensitive) because, in our view, intermediate declines in natural gas prices represent an opportunity for involvement in an extremely strong long-term bullish scenario. We became intrigued with Hugoton Royalty Trust (HGT, a natural gas royalty trust that also drills and expands their reserves) because the stock price had been pressured not only by softer natural gas quotes but also by a secular restructuring undertaken by XTO Energy. XTO had held over 50% of Hugoton, and distributed the stock to its shareholders. Among those shareholders were many who are not interested in income stocks (HGT will pay out somewhere between 7 and 10% this year, depending on natural gas prices) or who want more aggressive and risky plays in the energy world. These shareholders began dumping their stock to others, like us, who wanted it, and the shares experienced a hitherto unseen volume of trading. We estimated that this turnover produced a 10-20% negative downward bias in the shares, which essentially became our discount in a group that was already generally discounted by the flight of momentum investors. We were not alone, as insiders at HGT bought several million dollars worth of shares at the same time. So we think we've made the most



inexpensive possible bet on a high-confidence long-term trend of firm natural gas prices, and we're being paid to wait. We were happy to see a number of major Wall Street firms check in with buy recommendations in the weeks after we added our position—happy because we're small, centralized, and agile enough to act quickly and first when Mr. Market is in the mood to hand out gifts.

We bought Johnson & Johnson at less than 15 times next year's earnings estimates, catching what we believe will be the low for many years. Part of our strategy is to buy the highest quality companies at moments when they are out of favor, and this global franchise certainly fit the bill in that category. We sit with a small gain already, though it was diminished some by J&J's purchase of Pfizer's consumer products division late in the quarter. Some felt the price was too high, but in our view branded consumer products with global reach and distribution are something like natural resources now: there is a great wave of growth ahead as previously undeveloped economies create new

Quarter Composite Net of Fees*

Income-Equity*	2.9%
50/50 SP500 & Long Treas	(1.3)%
Russell 1000	(1.7)%

12-Month Composite Net of Fees*

Income-Equity*	9.0%
50/50 SP500 & Long Treas	1.1%
Russell 1000	9.1%

9-Year Composite Net of Fees*

Income-Equity*	7.3%
50/50 SP500 & Long Treas	7.1%
Russell 1000	6.2%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 6/30/06: 582 accounts in composite, representing 61% of total assets in the strategy with a dispersion of 0.12. Inception: 5/97. We offer a customized version of Income-Equity that excludes Master Limited Partnerships. These accounts are not included in the composite and represent 30% of the total assets in the strategy.

middle-class consumers at a pace and scale hitherto unseen in human history. J&J also gives us more international exposure in an increasingly “flattening” economic world, though you’ll never find it listed as an international stock on any categorical database.

We also bought Tenaris, a Norwegian play in oilfield services, as an opportunistic move when the stock declined sharply just before its semi-annual dividend. This worked well, and we’ll be selling shortly, capturing a 20+% move plus the dividend in less than a month.

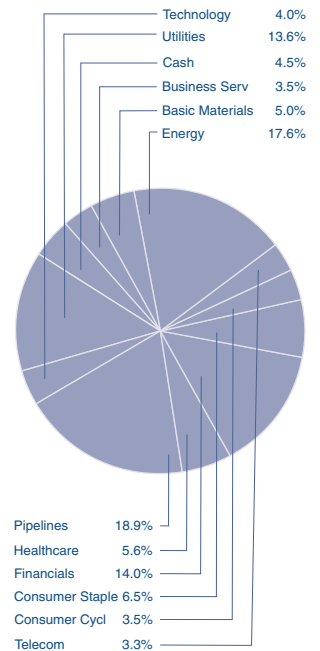
Last time we mentioned that UnumProvident was on our watch list due to a disappointing report in the first quarter. Though this may one day be a great turnaround story, it’s not happening yet as far as we can see. The convertible preferred shares we held matured and the common has only a small (and possibly at-risk) dividend, so we sold our position. We also sold Fidelity National Financial, on concerns about a slowing real estate market and its effect on their title insurance business. We also took profits of about 25% (plus dividends) in relative strength leader Campbell Soup, a stock that is fairly well placed in a market that might be emphasizing defensive stocks—but that had become fully valued in our view.

Generally, we were fairly well balanced among gainers and losers, with little regard to industry or sector, but many more of the gainers were heavily weighted positions in the portfolio and the losers much less so.

LOOKING FORWARD

Our valuations are fine relative to the market and relative to historical standards, and the gravitational pull of the broader market has prevented any of our stocks from becoming overbought. The market has brought down some stocks that were too expensive for us before, though, so we may make an effort to bring them into the portfolio, depending on how pricing develops during the quarter.

As of the end of the second quarter the portfolio yield stands at 5.1%. The five-year dividend growth rate in the portfolio is 10.3% (excluding special dividends) and the projected dividend growth is 6.3%. Assuming the projected dividend growth rate is achieved in the future, the income yield on a portfolio bought today will double in approximately 12 years, generating an income yield on original investments of over 10%—exclusive of any appreciation or re-investment. That’s the theory, in any event, and so far it has been realized. Note that the income yield can fluctuate depending on special dividends and dividend increases. Based on purchase plans we have now, we expect the full-year 2006 income-only yield for investors with us at the beginning of the year to exceed 6%. □



FUNDAMENTAL CHARACTERISTICS

Yield	5.1%
Proj Dividend Growth	6.3%
Payout Ratio	56%
Market Cap	\$36.2 Bil
Price/Book	2.8
P/E Ratio	14.3
S&P Rating	BBB+
Beta*	.50
R-Squared*	.50
Standard Deviation	11.9

*Relative to S&P 500, 6/30/97-6/30/06

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

Drumrolls! We're very pleased to announce our *Rising Dividend Plus* strategy is now open. We've been managing this portfolio for institutional investors since December 2004 using a methodology that is most akin to the principles and process discussed in Lowell Miller's recently published revised version of *The Single Best Investment*.

Rising Dividend Plus is diversified across the broad market. It's more assertive than our other strategies, with even greater emphasis placed on dividend growth—a factor with which we have worked closely for nearly twenty years. The stocks held are mainly large-cap value companies, though any size company may be used if it fits our most basic investment criteria: established and seasoned, with high financial strength and likely to provide steadily rising earnings and dividends.

Many studies, including our own, have shown that equities with rising dividends have consistently outperformed relative to broad market indices, with reduced volatility. We see dividend growth as the best signal from management regarding future prospects of a company—information that is more reliable than any brokerage analyst's or market pundit's opinion. Further, dividend increases certify

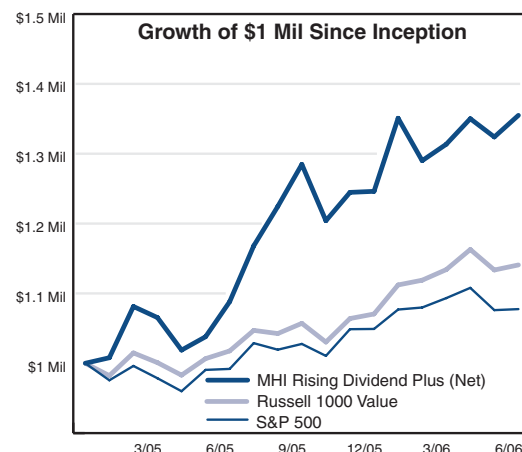
Quarter Composite Net of Fees*

Rising Dividend Plus*	3.2%
Russell 1000 Value	0.6%
S&P 500	(1.4)%

1-Year Composite Net of Fees*

Rising Dividend Plus*	24.5%
Russell 1000 Value	12.1%
S&P 500	8.6%

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 6/30/06: 2 accounts representing 100% of assets in the strategy, with a dispersion of 0.01. Inception: 12/04.



previously reported results. Over time, increases in dividends induce increases in the price of the equity producing those dividends.

That's the Rising Dividend part—a broad canvas covering nearly every industry, driven primarily by dividend growth rather than the absolute level of yield (our Income-Equity Strategy, for example, has a strong emphasis on absolute yield as part of its mission). The "Plus" includes dividend-paying stocks that may not rank the highest on dividend growth but offer something strong as compensation; stock buybacks, insider buying, special hidden or unpriced value, restructuring, or an extraordinary technical profile.

We believe that the best investment results for investors can be obtained by a combination of *discipline and flexibility* (a removal of some traditional constraints). Discipline means building a portfolio around the dividend factor. Flexibility means the portfolio may contain overweight position in certain sectors or industries, change weights to favor various capitalization sizes, and as market conditions warrant, hold greater cash than would be typical of a long-only portfolio. In other words, in addition to basic stock selection focusing on dividend growth and a continuing effort to maintain a diversified group of stocks, the portfolio is also characterized by an element of sector rotation, size rotation, and transitional cash—depending on market circumstances. Also unlike many

Rising Dividend Plus Characteristics

Size:	Large cap, though any size company may be employed.
Key Metrics:	>market dividend growth, >= market yield, <= market price/earnings, <= market price/book, >=market prospective earnings and revenue growth, <=market sector diversification, <=market volatility, >market average financial strength
Inputs:	Fundamental analysis, both quantitative and analytic. Technical analysis to enhance timing of buys and sells.
Turnover:	Estimated >25% and <100%
Concentration:	Up to 25% or two times S&P weight in any one sector.
Macro Themes:	Applied selectively
Holdings:	25-50, depending on availability of suitable investments (2-4% positions, to be considered somewhat concentrated)
Benchmark:	Russell 1000 Value, S&P 500
Cash:	Up to 50%, based on bottom-up candidates.
Selling:	Fundamentals do not live up to our expectations, valuations exceed our guidelines, or to make room for new candidates.
SRI:	Yes (see policy at www.mhinvest.com/sri.html)

other strategies, Rising Dividends Plus utilizes insights from the field of technical analysis—the study of actual price behavior—in addition to traditional tools of fundamental analysis.

This “fusion” style grounded on dividend growth has been quite effective. Since inception we have gained—in a difficult market—35.5% versus 7.8% for the S&P 500, 14.1% for the Russell 1000 Value, and 10.5% for the average large-cap value mutual fund. For the 12 months trailing ending June 30, our strategy, with a 24.5% return, was ranked number 1 of 350 large value managed account strategies tracked by Evestment, and if we were a mutual fund we would have been the number 1 ranked diversified large value fund in the Morningstar universe of 1350 funds, with the number two fund trailing by some 380 basis points. Our “secret sauce” during this period was extra weight in the better-performing energy stocks, and that is one of the strengths of the strategy; an ability to concentrate in sectors as market conditions warrant.

INVESTMENT OBJECTIVE

The Rising Dividend Plus objective is to provide investors with a stable and focused path to participate in the broad growth of equities. The goal of the strategy is to outperform a broad measure of the equity market, such as S&P 500 or Russell 1000, and to outperform large value measures such as the Russell 1000 Value. Safety during market declines is an additional target of the strategy, since risk control during declines is a major ingredient of long-term success. Improved performance during declines may be accomplished both through selection of lower-volatility stocks and the timely accumulation of cash.

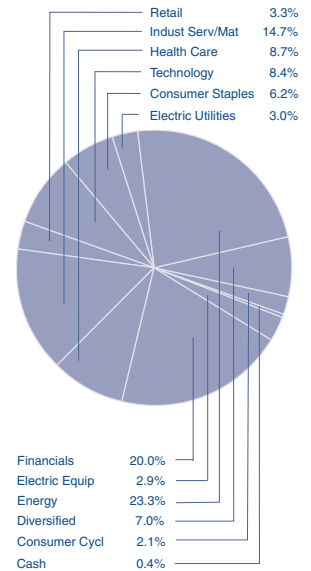
INVESTMENT STRATEGY

We search for companies that serve a proven market, favoring companies with a repeating-business model that have demonstrated success in their business. We always take the

position that we are long-term investors in an ongoing business with an established marketplace and a history of sound management. We seek a history of dividend growth as evidence that growth is “real” and that management is willing to share the fruits of prosperity with investors. Companies are screened for excellent financial strength—including low debt relative to their industry, among other balance sheet items—and conservative accounting practices. A premium is placed on reliability and certainty of future company success. Attractive holdings often have some protection against competition through market dominance, branding, geography, or intellectual property. Features such as growth of cash, stock buybacks, insider buying and overall insider holdings, consistency between revenue and earnings growth, financial reporting transparency, attractiveness as an acquisition, integrity of management, sound corporate governance practices, and corporate community citizenship are important factors in our overall analysis.

While we’re willing to concentrate, diversity is important. For the year to date, our leadership stocks have included natural gas, auto parts, retail, investment banking, medical supplies, motors, packaging, industrial supplies, office supplies, utilities, and pharmaceuticals. Losers included natural gas as well, conglomerate, insurance, medical devices, information systems, and industrial equipment. As you can see, we address the broad market, not just the market of high-yield stocks, and there is only minor overlap in names between this portfolio and our other strategies.

We suggest Rising Dividend Plus is appropriately viewed as part of a ‘core’ or ‘value’ asset allocation, and that its characteristics should keep it competitive in nearly all market conditions. In summary, we seek to make sound investments that will provide outstanding reward without undue risk—using all the analytic tools available.



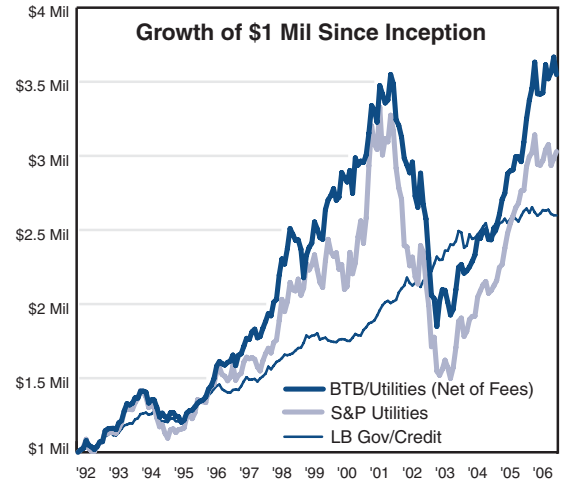
FUNDAMENTAL CHARACTERISTICS

Yield	1.6%
Proj Dividend Growth	12.0%
Payout Ratio	29%
Market Cap	\$55.6 Bil
Price/Book	3.5
P/E Ratio	17.6
S&P Rating	BBB+
Beta	NA
R-Squared	NA
Standard Deviation	NA

“Natural gas and growth of foreign economies seem to us to be two of the most fundamentally solid investable trends in the world we survey”

We had some wild riders with us this quarter, though our returns were still positive and our year to date performance remains quite respectable, a bit above the long-term trend. Our portfolio contains none of the Dow Jones Utility’s large electrics, which had something of a recovery (led, seemingly as always, by TXU), and has emphasized foreign phones and gas producers as sources of extra alpha—in addition to our more conventional distribution and integrated utilities. Those wild riders were momentum players in the foreign phones and gas stocks, who bailed en masse during the quarter. We’re still driving, though, while those riders seem to have been tossed out on the curve.

Natural gas and growth of foreign economies seem to us to be two of the most fundamentally solid investable trends in the world we survey. Though gas storage is quite full as a consequence of a record warm winter, we’re willing to bet that the weather normalizes and the supply/demand statistics for gas continue to argue in favor of firm or higher prices. A number of major buyout deals for gas companies tells us as well that the valuations investors have placed in these firms are substantially lower than the estimations of those who are actually in the business, giving us a margin of safety in maintaining our positions. As for storage levels, much is made in the press about these high inventories, but they only represent 12-14% of total usage. A cold winter will “disappear” these reserves quickly. And further damage in the Gulf of Mexico as a result of hurricanes (there are still significant facilities out of commission since Katrina et al) will pop up prices in a hurry. In any event, there’s no noticeable increase in gas production in the past few years when you net out new fields and declining fields, so one has to wonder what will generate higher flows if \$6 gas can’t do it. Some think LNG (liquefied natural gas) imported from other countries will fill the gaps, but intake



facilities are just now getting approvals, and there is considerable uncertainty regarding the availability of supplies. After all, China and India would like some LNG, and so would Europe. The time is long past when the US can just snap its fingers and cause energy to magically appear.

As for the foreign phones, we have some “old Europe” companies that are selling at lower valuations than our domestics, but the interesting phones are those from more developing areas. We consider these a proxy for economic growth in the wider world. It’s true that there are technological challenges for these companies just as our domestics are faced with problems, but regulation is far more congenial to these enterprises, which are often crown jewels (sometimes almost literally) and often the sole meaningful supplier, in countries whose consuming growth potential dwarfs our own right now.

PORTFOLIO HIGHLIGHTS

China Mobile (CHL) for example will soon have 300 million subscribers, perhaps 20% of potential, while Verizon, by contrast, has 53 million subscribers in a nearly mature U.S. marketplace. Not only does CHL have far to grow in China—generally protected by the

Quarter Composite Net of Fees*	
BTB/Util*	1.7%
Russell 3000 Utilities	4.1%
S&P Utilities	5.7%
LBGC	(0.1)%
1-Year Composite Net of Fees*	
BTB/Util*	11.5%
Russell 3000 Utilities	9.8%
S&P Utilities	5.9%
LBGC	(1.5)%
10-Year Composite Net of Fees*	
BTB/Util*	8.2%
Russell 3000 Utilities	3.4%
S&P Utilities	6.9%
LBGC	6.3%

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 6/30/06: 163 accounts representing 93% of assets in the strategy, with a dispersion of 0.16. Inception: 9/91.

government—the company is on the march globally, recently trying and failing to buy global operator Millicom. Many analysts have rather low price targets for CHL, but they must be looking only a quarter or two ahead. We see this more as AT&T in the early days. And the possibility of a rising Yuan, one of the factors that led us to the stock, would be a big plus for dollar-based investors in a mostly domestic Chinese company. Indeed, a weak dollar will benefit all of our foreign phone holdings, and though we don't have a strong view on the dollar near term, in the long term big things will have to change for the dollar to avoid persistent weakness. CHL, like PT Telekomunikasi Indonesia, finished up for the quarter, but it was a roller coaster ride, as the stocks corrected sharply from prior good performance when emerging-market types picked up their marbles. Brasil Telecom and Telefonos de Mexico weren't as fortunate, providing a drag on the portfolio, suffering in part from the inevitable zigs and zags of Latin American politics. Though TMX will have to deal with the results of Mexico's presidential election (and a bad result could cause us to exit), Brasil Telecom remains the value play and acquisition target we believed it to be when we first entered the position near current pricing.

Our gas stocks were a weight, but only a mild one, as deals came flowing for gas companies late in the quarter, reminding investors of the values available and jump-starting them on a treasure hunt for the next candidate. We have a few of those, including Questar and newly land-based Pioneer. In truth, although our Anadarko declined in price on news of its deals for Kerr-McGee and Western Gas, we think the deals made a lot of sense as transactions which could be paid for by hedging proven reserves into the future, and we think that Anadarko itself could become a candidate for acquisition by a major energy company. So

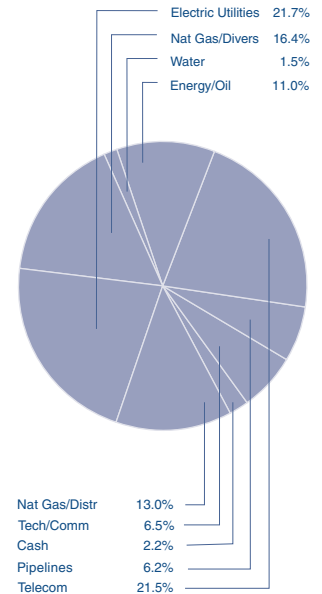
investors need to stay tuned, and hold on to the case for long-term value creation.

Elsewhere Dynegy led our winners, though without any stock-moving news. Perhaps Mirant's abortive takeover offer for our NRG may have had something to do with it. Nisource rose; it's been a while since this company helped our returns. Our thought is that many pipeline assets are changing hands in the MLP area, and there may be a renewed focus on what attracted us to NI in the first place—Columbia Gas Pipeline, the largest pipeline running east from the Mississippi. Southern Union also rose as an activist hedge fund shareholder proposed creating an MLP, buying back stock, or selling the company. We'd be OK with any of those alternatives.

No sooner did we buy Sprint than a soft earnings report provoked skeptical views on the Street about the company's ability to integrate with Nextel, and even their ability to hold on to Nextel's premium type of customer. We don't often get nicked on a new buy, and it dampens our spirits, but we think the jury has not even gone out yet on this one. We see it as a leading contender for growth among domestic telecoms, and at current prices it must be seen as well as an acquisition candidate for European or even Asian companies that have become locked out of the US wireless market.

LOOKING FORWARD

We considered a higher level of activity last quarter, but found ourselves content with what we held. A few of our ancillary positions in enabler or service type companies might change shape over the summer, but basically we like what we hold. A slightly surprising revival in interest among large electrics should help support our traditional utilities, and the post-correction revival of our more aggressive names seems already underway. □

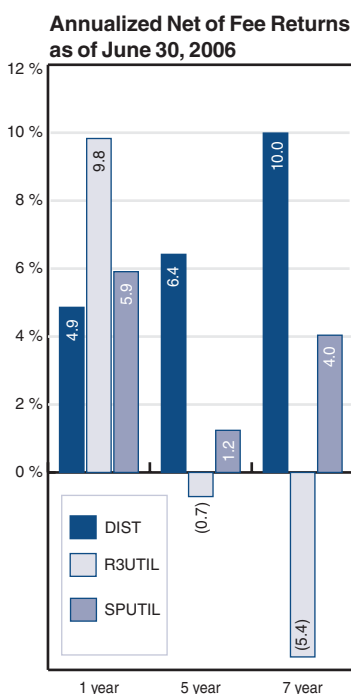
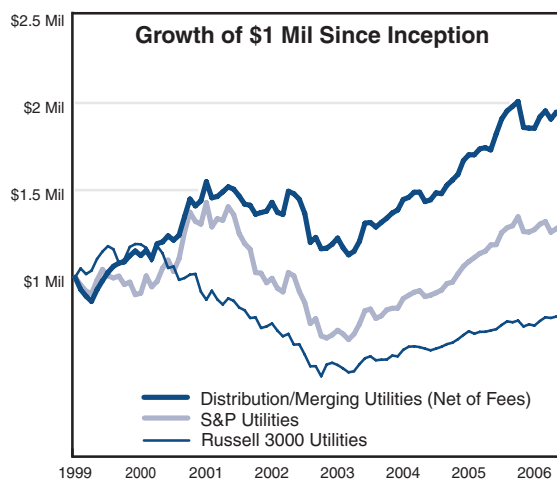


FUNDAMENTAL CHARACTERISTICS

Yield	2.9%
Proj Dividend Growth	7.1%
Payout Ratio	46%
Market Cap	\$19.6 Bil
Price/Book	2.8
P/E Ratio	15.9
S&P Rating	BBB+
Beta*	0.6
R-Squared*	0.4
Standard Deviation	14.0

*Relative to S&P500, 6/30/96- 6/30/06

It was another good quarter for the Distribution/Merging Utilities Strategy, but nearly as important as the solid returns was the relative tranquility of the portfolio during a quarter characterized by plenty of rock and roll (verging on heavy metal) in the broader market. Too, a background of continuing interest rate increases would normally cause the naïve to think that these stocks should have had problems—in fact the correlations are so bad that only financial news reporters believe they exist at all(!) We’d never suggest that every quarter will be a walk in the park no matter what the other markets are doing (after all, *Nemesis* might be listening), but positive results without correlation to either credit or equity markets are not uncommon for this strategy, and that is one of its most attractive features—in addition to M&A potentials.



It’s really quite simple: you can buy a company today at less than \$4 gas equivalent (including takeover premium), and you can sell that gas into the futures market as a hedge at \$7-9, thereby locking in your cost to acquire the company over some years. In a world of high-priced product whose producers have increasing trouble finding new supply, the notion of prospecting for natural gas on Wall Street rather than out in the nasty weather will hold continuing appeal for both operating companies and financial players. We’ll see volatility along the way as a function of cash prices for gas, but we think on balance that volatility will be net positive (in the near term, much depends on hurricane season), and the fact is that industry equity prices have never caught up with the increases in product prices since the inception of the “new” energy world a few years ago—so there remains a margin of safety.

PORTFOLIO HIGHLIGHTS

We had another takeover offer in the portfolio during the quarter, with a 45% gain in a fully weighted position in Western Gas Resources. The acquisition is for cash, by Anadarko Petroleum, a natural gas-focused company. Western Gas just “fit” into the portfolio by virtue of its distribution operations, though over time its natural gas assets, like those of Questar, have come to dominate the value represented by the company. It happens that our view of the natural gas industry, in which we have something of a specialty, is very similar to our view of the utilities industry when we started this portfolio: a wave of consolidation is clear in the present and the visible future. So, at moderate weight due to their differing volatility, we may be willing to add some of the best natural gas takeover candidates to the portfolio in replacement of WGR, even if their actual utility presence is *de minimis*.

There weren’t any deals directly in the utility industry, but there were a number of transactions in which financial players were parties, as we’d suggested last time they might be, and there were many announcements relating to assets, if not entire companies—so the pot continues to simmer. Mirant, recently emerged from bankruptcy, offered to buy NRG. In the MLP space (also an industry ripe

Quarter Composite Net of Fees*

Distribution (Prelim)	4.9%
Russell 3000 Utilities	4.1%
S&P Utilities	5.7%
S&P 500	(1.4)%

1-Year Composite Net of Fees*

Distribution (Prelim)	4.9%
Russell 3000 Utilities	9.8%
S&P Utilities	5.9%
S&P 500	8.6%

7-Year Composite Net of Fees*

Distribution (Prelim)	10.0%
Russell 3000 Utilities	(5.4)%
S&P Utilities	4.0%
S&P 500	0.5%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 6/30/06, 223 accounts, representing 97% of total assets managed in the strategy with a dispersion of 0.28. Inception: 1/99.

for consolidation, which we may add to the portfolio), Plains All American bought Pacific Energy Partners. Dynegy sold a significant plant to Duke. Both NRG and Texas Utilities announced major plant construction initiatives. Vodaphone turned down Verizon’s offer to buy VOD’s shares of Verizon Wireless, Sprint bought UbiqTel and Nextel Partners, China Mobil attempted to buy Millicom, Suez is being acquired by Gaz de France—the beat goes on...

We weren’t especially active in the portfolio during the 2nd quarter. We sold California Water for a gain of about 50% on our original cost, on the thought that it had reached unsustainably high valuation. Now that the stock has declined by 25% since our sale, we need to review it for possible inclusion once again (and figure out how to time every other stock just as well). We sold Century Telecom on valuation concerns, aggravated by various legislative initiatives and uncertainty about the status and rules for the Universal Service Fund that greatly benefits rural telecommunications companies. Here too, at the right price we can get interested again, assuming the regulatory background is clarified.

We brought Sempra Energy back into the portfolio, after about a year’s absence. You may recall that we sold the stock due to the potential risks stemming from lawsuits in California—one never knows what crazy results will come out of a California courtroom. Now the threat from those cases has died (from a dwindling of the cases as well as recently announced settlements), and what is left is the cheapest large utility with the best natural gas franchise in North American and an excellent electric franchise with a growth demographic, one of the strongest presences in new LNG terminals, and a consistently profitable trading operation that actually appears to degrade the PE awarded to the company though with the

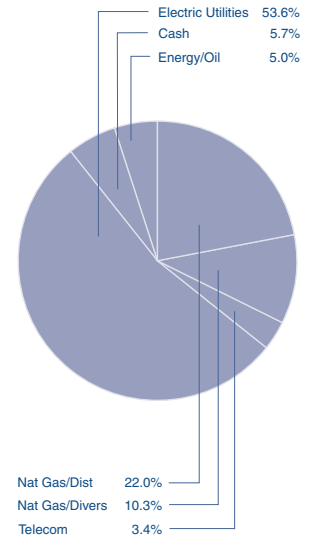
other hand it boosts financial results. Having recently sold about \$1.2 billion of assets, SRE is a candidate for a strategic buyer such as Edison International, and it is so cheap it should also be of interest to a financial buyer.

We also bought Sprint. Though this purchase hasn’t worked out well as yet, we think it’s an attractive situation with plenty of future internal growth ahead at a modest price today. And it’s just about the only game in town for a foreign buyer who wants to establish a mobile telecom business in the U.S at reasonable scale. We like the stock—now a pure-play mobile company, with the spinoff of its landline business—without a deal, but also have little trouble envisioning a buyer or two (Deutsche Telecom, Vodaphone after it sells its stake in Verizon Wireless, British Telecom, even Telefonos De Mexico or its cellular sister America Movil, to name a few).

Elsewhere the portfolio was a kind of inchworm, with many stocks that had not done so well recently picking up their oars and rowing like they should (FE, DYN, SUG, SWX, NI, XEL, WR, LNT, etc) and just a handful of previously stronger issues moving down modestly (TE, SRP, VIP, EAS).

LOOKING FORWARD

The buyers are active, whether it be for companies or individual assets, and we still haven’t seen that much from Europe yet, so there is surely more activity under the surface. We’re content with this portfolio even when there are no deals, but the prospect for M&A changes does seem to be providing support for prices now, and we think there are more transactions in the offing. While the Fed’s program of rate increases doesn’t seem to have hurt the portfolio much, a pause could still only be viewed as a potential positive. □



FUNDAMENTAL CHARACTERISTICS

Yield	3.1%
Proj Dividend Growth	5.6%
Payout Ratio	49%
Market Cap	\$5.6 Bil
Price/Book	1.9
P/E Ratio	16.7
S&P Rating	BBB+
R-Squared*	0.4
Beta*	0.2
Standard Deviation	13.0

*Relative to S&P 500, 6/30/00 - 6/30/06



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PORTFOLIO	FOCUS	YIELD	EST. GROWTH OF YIELD	5-YEAR BETA	P/E	1-YEAR NET OF FEES RETURN
Income-Equity Strategy	Dividend growth companies, broad market	5.1%	6.3%	0.7	14.3	9.0%
Rising Dividend Plus	High financial strength companies steadily raising earnings and dividends	1.6%	12.0%	NA	17.6	24.5%
Better Than Bonds/Utilities	Utilities sector: natural gas, electric, telecom, and water	2.9%	7.1%	0.8	15.9	11.5%
Distribution/Merging Utilities	Local distribution utilities, takeover candidates	3.1%	5.6%	0.6	16.7	4.9%

as of June 30, 2006



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