

**THE STRATEGIES****INCOME-EQUITY STRATEGY**

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

**RISING DIVIDEND PLUS**

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

**BETTER THAN BONDS / UTILITIES**

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

**DISTRIBUTION / MERGING UTILITIES**

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

**A** year ago, in our July 2006 report, we noted, "...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 market conditions." Well, here we are 20 percent-plus later, after a broad and consistent strength across nearly all segments of the market, and the question is obvious: are there still enough straws to make a basket?

The ten points we often cite are rather neutral, with both economic and market factors slightly tilted toward bullish. Valuations are obviously up over the last year, but the market can go higher based on the Fed model (in rough terms, the classic PE as a multiple of the reciprocal of the bond rate), and the economic figures are good enough to support the earnings that would be required. Insiders aren't bullish but selling has waned. Sentiment indicators are mixed, our proprietary indicator remains on the buy signal it first suggested in winter of 2003 (unusual, since it's not really a long-term kind of indicator). The thrust-and-parry of reasonably strong employment up against rising energy, food, and financing charges also results in a kind of stalemate. The derivatives market remains a looming spectre.

Yet, two factors stand out here, and there is potential for them to become touchstones for continuing stronger markets: the dollar, and an unusual technical moment.

We think the dollar deserves special attention—it is a wild card. While "The Almighty European Union Euro" hardly has the poetic ring of "The Almighty American Buck," the Euro has risen about 60% over the past five years. Institutions and consultants, forever running to try and catch up with the train, cannot hire international managers fast enough. Individuals, too, goaded by advisors and media, are all heading through the International door in the mutual fund building. Futures traders—this crowd made huge wrong-way bets on interest rate decreases early this year—are massively short the dollar, relative to the Euro. In sum, the view known as "weak dollar" has attracted one of the most monolithic consensus crowds we have ever seen.

Well, as we all were taught by grandpappy, no Euro grows to the sky. We find it hard to believe that there's been a 60% change over the past five years in the relative appeal of the U.S. and Euroland. Europe has improved, but it remains slow-moving, inefficient, and bureaucratic compared to the U.S., with every bit as much economic threat from Asian producers. Either everything has changed, or the currencies were totally mispriced before, or they are totally mispriced now. After all, a currency isn't a pink sheets stock, fluctuating for no reason. It's a reflection of business flows, confidence and credibility, and relative interest rates. None of these factors sufficiently explain why a new iPhone is \$495 in the U.S. and \$620 U.S. equivalent in Germany in Euros. To us, that looks like a 20% overshoot on the Euro. A correction of that amount would retrace about half the Euro's relative gain since 2002—and we'd then feel that all's right with the world again.

Euro rates are creeping higher even as the U.S. Fed is trying to avoid increases, which doesn't augur well for the dollar near term. But rates aren't *the* deciding currency factor, otherwise the dollar would not have declined so much in recent years, when U.S. rates were higher than in Euroland. And the weak

<b>TABLE OF CONTENTS</b>	<b>PAGE</b>
MARKET OVERVIEW	1
INCOME-EQUITY STRATEGY	3
RISING DIVIDEND PLUS	6
BETTER THAN BONDS/UTILITIES	8
DISTRIBUTION/MERGING UTILITIES	10

*“So, the dollar as dark horse may rise in bullish importance in the coming quarters. And there is an unusual technical circumstance that implies, to us, that something, some ‘unknown unknown’ to use Rumsfeld’s famous phrase, may be rising in importance.”*

dollar can still benefit certain domestic investments. Recall that when the yen was mighty in the late 1980’s, the Japanese came to buy what seemed to them cheap U.S. assets, like Rockefeller Center in New York. Asset-rich U.S. companies, as well as U.S. companies with a strong export presence, should be of interest to any Euro investor who believes that times change, the world turns, and the weak become the strong. Even as we write VW is considering a plant in the U.S.—because the costs are so relatively low. A utility that appeared in most of our portfolios was taken over by a Spanish company this quarter—and it won’t be the last, as while our utilities and infrastructure operators may look expensive to us, to Euro investors they’re on the bargain counter.

U.S. assets, from land to pipelines to office buildings, are cheap to overseas buyers with a long-term vision. How cheap is the U.S. to a European right now? We may be feeling prosperous and “near new highs,” but translated into Euros the Dow and S&P indices are not near new highs, they’re down by roughly 30% since 2000! Translated into gold prices (it might be that gold is the new dollar) the S&P is down more like 50% since 2000.

Euro stocks appear to have performed better and continue to draw new investors in the belief that the Euro will be as strong in the next five years as it was in the past five years. Hmmmm. As they did in the early 1990’s, institutions, consultants, and strategists have confused market performance with currency performance, and we think the Euro is more likely to have reached an extreme here than to have certified its perpetual superiority. We’re not suggesting a giant reversal is in the cards for the next month, but we’re skeptical about a \$2 Euro. We’re not against owning the right overseas stocks—we merely deny the number-crunchers’ imaginings that the European “asset class” will outperform in the future for the same reason it outperformed in the past.

So, the dollar as dark horse may rise in bullish importance in the coming quarters. And there is an unusual technical circumstance that implies, to us, that *something*, some “unknown unknown” to use Rumsfeld’s famous phrase, is afoot. Since the February market reaction on Chinese market worries (this has become a

“known unknown” and no longer matters), volume in the U.S. market has increased to a high and record-setting pace. Dollar and share volume, especially in March and June, have been at the highest levels ever seen. When we slip on our technical helmet we can say without hesitation that rising volume, higher-than-normal volume, and especially new record volume, are among the first and most significant aspects of the market landscape to attract our attention. Put simply, this shows a level of interest much higher than it was before. It has also been our observation that *every major new bull market rally begins with new record volume*. Louise Yamada put it poetically; “volume is the weapon of the bull.”

But this manifestation is perplexing. We’ve never seen record volume of this type appear when the broad market has most recently moved noticeably higher. Yet the odds are against a form of topping activity. Tops aren’t typically a mirror image of bottoms—volume is more likely to die at tops (marking a kind of exhaustion) than to build and build as has been happening for nearly the entire first half.

If we could eliminate the fact that stocks are not at a bottom and view the volume pattern in a void, we’d depart from our usual milquetoast prevarications and pound the table bullishly. It doesn’t really matter that much to our portfolios, since we stay mainly fully invested, but it should be a comfort to any stripe of investor that each small decline is met with rising volume—a message that has remained, for months, supportive.

Will the dollar turn up? Will stability come to Iraq and/or our huge expenses there come to an end? Are investors anticipating the long-term economic and geopolitical salutary effects of what has become a mobilized, serious, and industrial-strength effort to develop alternative sources of energy? Is it just hedge funds gettin’ jiggy wid’ it? We’ll see, but this unusual volume pattern stands out, resistant to the bearish chorus of obvious threats. Investors are buying in, with activity that’s *not* reminiscent of the tech bubble. We just don’t quite know, to paraphrase Bill Clinton, what “in” is. There’s no need to get mystical, but the phenomenon is rare, and it should keep us alert, in our view, for positive developments. □

---

#### SELECTED INDICES

	2 <sup>nd</sup> Qtr07	12 Mo
<b>S&amp;P 500</b>	6.3%	20.6%
<b>Equity Inc</b>	4.9	20.8
<b>Util Fund</b>	3.9	31.4
<b>R3UTIL</b>	3.4	29.3
<b>Long Bond</b>	(3.2)	4.8
<b>R1000</b>	5.9	20.4

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

---

**PIE-ON-THE-TABLE.** We're wearing party hats and waving streamers this quarter, celebrating the 10-year anniversary of our Income-Equity Strategy. It has been an excellent decade for us and our clients, resulting in high risk-adjusted returns through times of both falling and rising interest rates, a tech bubble up and down, a terrorist disaster, wars on several fronts, Democrats and Republicans, shifts in world economic power, rotations between prosperity and decline across the panoply of economic sectors. Investors have come to see that true investment is not so much about placing lots of chips on different categories and classifications of equities, but rather it is all about being a partner in well-positioned businesses that have the ability to provide a reasonable and sustainable level of consistent growth over long periods of time. Since inception, and particularly since year 2000, when "pie-in-the-sky" became "pie-in-the-face," we continued to provide "pie-on-the-table."

This milestone moment has induced reflection on our basic premises and investment philosophy, and we've been reviewing in our minds just why the execution has been successful. At bottom, even before we look at a single company, we're working from a financial model, a naked principle from which success seems inevitable if it can be effectively implemented. The model is simple: increasing cash flow will, over time, induce a concomitant increase in the value of the instrument (business) producing that cash flow.

Imagine a bond with a \$5 coupon. If an issuer decided for some reason to double the coupon to \$10, what would happen to that bond? Its value would double, of course, to match the doubling of the cash flow it produces. An investor would own a bond worth twice as much, which produces twice as much income. A carefully selected portfolio of high-yielding stocks can generate this same effect over time. As the dividends increase the value of the companies producing those dividends will increase as well.

But there is many a slip between cup and lip. The market in which stocks trade is a boiling

cauldron of crosscurrents and conflicting forces, over-discounted certainties and never-discounted unexpected events, a mish-mosh of opinions and feelings and changing positions and human frailties hovering just this side of chaos. Why is it that in this protean world one strategy can survive and prosper, while many others have a flowering moment in the sun only to shrivel in the cooler evening?

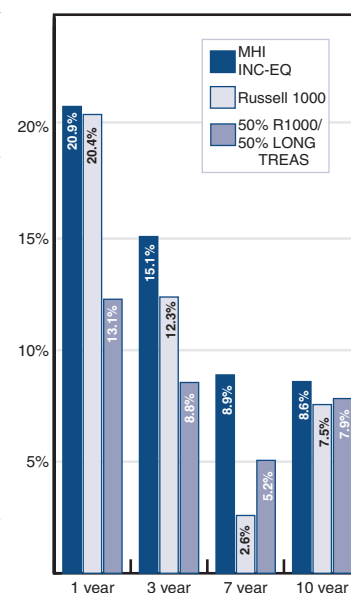
It seems that every day we have a renewed appreciation for the role of dividends in imposing some degree of silence in a world seemingly fabricated from noise. First, a dividend increase is the best and clearest information about the future prospects of a company—a message from those who know best about what's really happening. Equally as important, a substantial dividend (one that's competitive with fixed income, for example) provides a measure of stability for equity holders that's not available in other stocks.

Consider a simple PE (price/earnings ratio) model. Investors will pay a certain multiple of earnings for a stock, depending on their evaluation of earnings quality, sustainability, and potential for growth. In theory, if the earnings rise, so will the stock price. But we all know this theory is flawed, because there is a degree of subjectivity in assigning "the multiple." The flaw in the theory is revealed by stocks such as Wal-Mart or Home Depot, which are earning twice as much as they were at the turn of the millennium, yet sell at lower prices. Obviously, the PE was "too high" then. Or is it "too low" now? The instability of PE's is reflected in the general volatility of stocks: it is perfectly normal for even low-volatility stocks to fluctuate more than 30% from high to low during a year, *yet the underlying businesses rarely change that much.* The upper and lower PE ratios "assigned" in the marketplace create a kind of volatility band, and if investors buy at the high end of that band—well, it's just too bad.

Yet few observers have noted that one of the residuals of a high current yield is that it narrows the PE band, therefore reducing

*"Investors have come to see that true investment is not so much about placing lots of chips on different categories and classifications of equities, but rather it is all about being a partner in well-positioned businesses that have the ability to provide a reasonable and sustainable level of consistent growth over long periods of time"*

Annualized Net of Fee Returns as of June 30, 2007



*“Yet few observers have noted that one of the residuals of a high current yield is that it narrows the PE band, therefore reducing the volatility—especially the downside volatility—of higher-yielding stocks.”*

the volatility—especially the downside volatility—of higher-yielding stocks. These stocks will continue to rise over the long term based on their sustainable earnings growth, but they will also fall less because the *cash flow* they produce *has a value of its own, which can be priced on its own* relative to fixed income. This separate value is not to be found in non-yielders. And, of course, the rising cash flow (paid from rising earnings) induces increases in the value of the stocks producing that cash flow, making them far better examples of “PE theory” than the run of the litter. So, in a higher-yielding portfolio you are buying the potential future value of earnings—as discounted by an inscrutable certainty factor—and you are buying the current cash flow plus its estimated increases (which should track the increases in earnings). It’s a two-fer.

The dividend acts as a kind of therapeutic antidote to valuation volatility bands. And did we mention that dividends, unlike price changes, are always positive?

**Quarter Composite Net of Fees\***

MHI Income-Equity*	4.0%
50/50 R1000 & Long Treas	1.9%
Russell 1000	5.9%

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

MHI Income-Equity*	21.0%
50/50 R1000 & Long Treas	13.1%
Russell 1000	20.4%

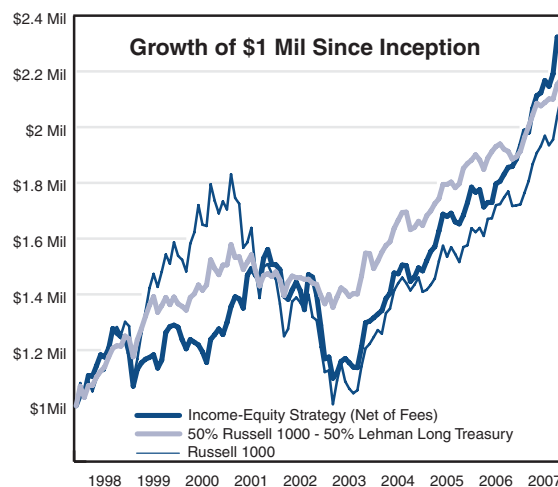
**10-Year Annualized Composite Net of Fees\***

MHI Income-Equity*	8.6%
50/50 R1000 & Long Treas	7.9%
Russell 1000	7.5%

\*Preliminary Returns. Included are all unrestricted portfolios that have been managed for one full quarter. As of 6/30/07: 857 accounts in composite, representing 67% of total assets in the strategy with a dispersion of 0.16. Inception: 5/97. We offer a customized version of Income-Equity that excludes Master Limited Partnerships. These accounts are not included in the composite and represent 21% of the total assets in the strategy.

**PORTFOLIO HIGHLIGHTS**

Gains came from a nice variety of stocks this past quarter. Bayer continued the strength we’ve seen since last fall (the stock is up 50% since October) with a 17% gain, helped by firm Euroland markets in general, and by raised guidance based on the integration of its Schering AG purchase. It was joined by Schering Plough (US company, no relation)—though the health group was only minimally positive for the quarter, with a return over 15%. Schering reported earnings more than 30% above expectations and important new potentials for Remicade. RR Donnelley continued to appreciate, this time with some help from takeover buzz in addition to a solid double-digit earnings gain on a gain of over 20% in revenues—quite impressive for an old economy printing company. Relative newcomer Aircastle gained attention with a large dividend increase and rose 12%. VF Corp’s growth renewal saw a modest acceleration, and the stock price followed suit, up 10% on the quarter. Our



Canadian Income Trusts Enerplus and Precision Drilling rewarded our patience earlier this year and provided solid gains as well.

We took some gains in stocks that were extended or had performed in line with our intentions. OKE, which had been in this portfolio for some years, was sold at double its cost (don’t let anyone tell you that money can’t be made in dull stocks!). We thought the stock had reached fair value, and we kept its growth driver, ONEOK Partners. Likewise, Equitable Resources had climbed so high that it’s yield was too low to justify continued exposure. We’d bought Crescent Real Estate as a high-yielding takeover candidate. Indeed a bid emerged for the company during the quarter, and, though it was lower than we’d originally hoped, we didn’t think there would be a higher offer (this company has a few burdensome complexities) so we moved on. We also sold British water company United Utilities, though it wasn’t really our choice. The stock “went dark,” delisting its ADRs and withdrawing its SEC registration, basically to escape the burdens of Sarbanes-Oxley. We don’t hold “pink sheet” companies that are not listed on major exchanges, and we don’t hold ADRs or companies that aren’t registered. This is a little sad, since there’s nothing wrong with UU and we could have envisioned holding it for many more years, or at least until the massive beast of utility consolidation in Europe ingested it.

Utilities—where we currently have fairly

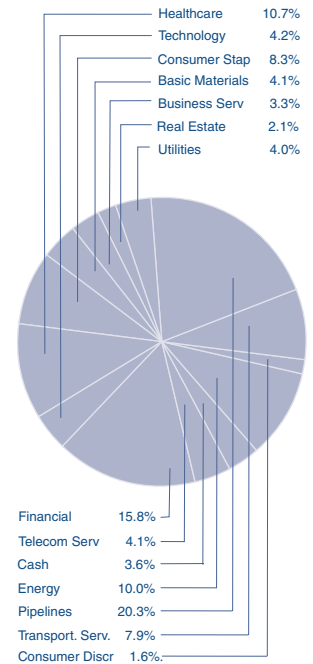
light weight for an income-oriented portfolio—both gave and took away late in the quarter. NiSource reported the results of an extended evaluation of alternatives for the company, and decided to do nothing, prompting a 15% loss for the quarter. We'd borrowed this one from our Distribution/Merging Utilities portfolio as a good utility consolidation candidate, and we still think it's a sound holding. Their Columbia Gas pipeline is irreplaceable, and sooner or later one of the many many many acquirers in the pipeline industry will come calling. Not many utility mavens liked Energy East, either, but in our view it was the cheapest domestic utility, with plenty of room for improvement and pretty good demographics (though arguably hindered by difficult regulation). Apparently Spanish utility Iberdrola (the largest utility in Europe) agreed, offering a substantial premium for EAS which more than wiped out the NiSource loss. Though the offer was good relative to recent EAS pricing (a 26% premium), we think there's a reasonable chance of another bidder and we continue to hold for now.

We entered Diamond Offshore early in the year to gain oil service exposure along with its \$4 special dividend (5% annual). We continued to hold as a rally in service stocks played out, then took profits for a total return of over 15% in about 6 months (the regular dividend is too low to maintain this one as an ongoing position in the portfolio). Special dividends, when paid as a "prosperity bonus" and not as some kind of cynical financial maneuvering, embody many of the positive aspects of regular high dividends with growth, though we're often unable to hold the stocks for the long term due to a low regular payout. Still, if we think the total return bottom line result will be good, it helps the portfolio and helps the overall cash flow, though these positions are often of shorter duration.

Among our additions this quarter, replacing the profit-taking enumerated above, we added one more special dividend stock and several rather high-yielders, each with a "story." Intercontinental Hotels has, like many European stocks, a history of making large payouts from

profits in the June quarter. This year the company voted a \$4.00 special payment. That caught our attention, especially because there is in process a global consolidation in the hotel industry much like the global utility or bank consolidations, and IHG's valuation and assets make it a prime target. Even without any M&A, though, we were comfortable taking a position because the trend in the hotel industry is a bifurcation between asset-owning companies like REITs, and manager/operators, or "asset-lite" players. IHG has attractive assets that could easily bring two-thirds of its stock price, in a market characterized by substantial under-supply and little new building relative to the under-supply. Further, respected investors the Barclay brothers had recently added one percent of the company, and then one percent again, to their eight percent position. Given that this is a solid name with a good assets, a good growth record and clear shareholder-friendly payout policy, it seems from the "story" that there are many possible ways to win.

We added to our position in aircraft lessor Aircastle (up 13%), a company specializing in financing for non-US air carriers. Shortly thereafter the company increased its dividend by 20%, for a current yield of 6% and looks to be rather cheap on recent growth rates. Airlines have a great need for new planes, but cash to buy them is tight, so business is good for AYR and should remain so on a multi-year basis. Diana Shipping is a dry bulk carrier with a focus on southeast Asia, and we think China and associated regional growth will keep a wind to its back (though these boats no longer use sails). We looked in the mirror and immediately bought Brookdale Senior Living, which raised its dividend by 11% literally the *next day* (!). We joined insiders who've been buying the stock massively, and while it appears on the surface that earnings don't support the dividends, there is tremendous non-cash depreciation here hiding ample cash flow from the tax collector. This company is unaffected by Medicare or such issues—residents pay cash—so it is a health care item for whom any swings to the



#### FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	5.4%
<b>Proj Dividend Growth</b>	9.9%
<b>Payout Ratio</b>	59%
<b>Market Cap</b>	\$40.1 Bil
<b>Price/Book</b>	2.7
<b>P/E Ratio</b>	15.9
<b>S&amp;P Rating</b>	BBB+
<b>Beta*</b>	.54
<b>R-Squared*</b>	.50
<b>Standard Deviation</b>	11.6

\*Relative to S&P 500,  
6/30/97 - 6/30/07  
(Weighted Averages)

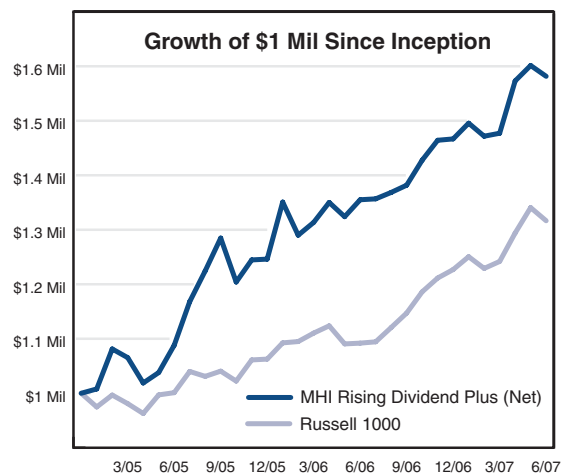
Continued on back cover...

*“As in all of our strategies, we look for the best investments within a discipline or theme. Here, “dividend growth” is the central theme.”*

**R**ising Dividend Plus is an assertive strategy focused on stocks with the best overall potential from the universe of stocks that offer above-average dividend growth. While it contains mostly large-cap stocks, we often use holdings from other cap ranges. As in all of our strategies, we look for the best investments within a discipline or theme. Here, “dividend growth” is the central theme, but there are many attributes that determine which stocks will finally enter this fairly concentrated portfolio, which we note below. In conventional “style” categories RDP fits best as Large-Cap Core/Growth, with portfolio holdings most often characterized, in our view, as GARP, or growth at a reasonable price.

Why dividend growth? It’s the best signal from management about the future prospects of a company, the best statement that yes, things are going well and are expected to continue so. It’s far more reliable information than an analyst’s opinion, the pandering of some talking head on TV, or of some young journalist who writes a company up for a financial periodical. Boards don’t vote higher payouts if the company can’t afford it. Why not? It’s a human thing: a dividend cut is basically the mark of management failure. To raise the dividend and then cut it shortly thereafter? You might as well start taking Hara-Kiri lessons.

Interestingly, some researchers have concluded that a dividend increase is also the best indicator that a company’s past reporting was, in fact, accurate. In these recent years of widespread “restatements” after the passage of Sarbanes-Oxley, one would be hard put to disagree with them, even without seeing the data. The real problem is that a company’s books (and tax records) are never exposed to investors in any absolute sense. You can’t go in and look at them. You’re forced to take management’s word for it. So to some extent all investors are backed into a corner and forced to read tea leaves, to try to determine the veracity of reports as well as management’s verbal statements about the future. A dividend increase goes a long way toward confirmation. So do substantial management holdings. So does insider buying. So do favorable industry



conditions. So does consistency between revenue and earnings/cash flow trends. We look at all these, and more, in a quest for the best dividend-growth stocks.

## PORTFOLIO HIGHLIGHTS

At Miller/Howard our path to seeking superior risk-adjusted returns often involves an effort to decline less than the markets during difficult times, and keep pace during positive times. That works, but we also like the mirror image, to outperform during rising markets and return no less than the markets when the rains come down. We’ve been doing that since inception at the end of 2004, and outperformance this quarter was especially gratifying because it was difficult to achieve. There was very little distinction between capitalization sizes, and little as well between growth and value styles. Basically everything went up until June, and then everything went down. The homogenous “correlation” was abnormal, or so most investment professionals are hoping. Add in the fact that “dividend stocks” were one of the weaker categories of equities, and it’s clear that solid stockpicking won the day.

Mercifully, we had plenty of sprightly issues and few that didn’t participate. Indeed, even those that didn’t participate on a price basis still delivered mostly positive fundamental news—nearly all of our stocks exceeded analysts earnings expectations, as was the case in the first quarter.

### Quarter Composite Net of Fees\*

Rising Dividend Plus*	7.3%
Russell 1000	5.9%
S&P 500	6.3%

### 1-Year Composite Net of Fees\*

Rising Dividend Plus*	17.0%
Russell 1000	20.4%
S&P 500	20.6%

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

Rising Dividend Plus*	20.7%
Russell 1000	14.6%
S&P 500	14.4%

\*Preliminary Returns.

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 6/30/07: 18 accounts representing 97% of assets in the strategy, with a dispersion of 0.06. Inception: 12/04.

The market is humbling, and sometimes it seems the days are just one unexpected setback after another. So we'll jump at the chance here to mention our most heavily weighted stock, Whirlpool, which reported earnings some 50% better than analysts' expectation (what were they thinking?) and jumped more than 30% this past quarter. That's right, Whirlpool, the one that compelled us to channel Jim Cramer and write, quote, "Let's just step out of character and call this one a future winner."

OK, we just boasted. Now we're over it, ready to worry about all that can go wrong, which is basically the essence of our job. Among the better stocks this quarter, Anadarko, Devon, and Pioneer rallied back in the energy group, though natural gas prices went in the opposite direction. The first two reported sharply higher than expected earnings, while Pioneer has a revived constituency as a result of its move to create an MLP for some of its assets. Intel is winning its war with smaller AMD, and the stock rose over 20%. Caterpillar continued strong, also up over 15%; it's an almost pure embodiment of the infrastructure theme that we believe is the global economy's sweet spot now. The company beat expectations by over 10%, and raised its dividend 20%—and this is without the help of the housing market. Air Products guided higher, American International Group beat expectations and may finally be past both the disturbances of the past few years and investor skepticism or risk aversion. Tyco rose in anticipation of its split-up, Southern Union in anticipation of its rationalization of assets, Emerson moved into new all-time high territory on the heels of its usual solid earnings report.

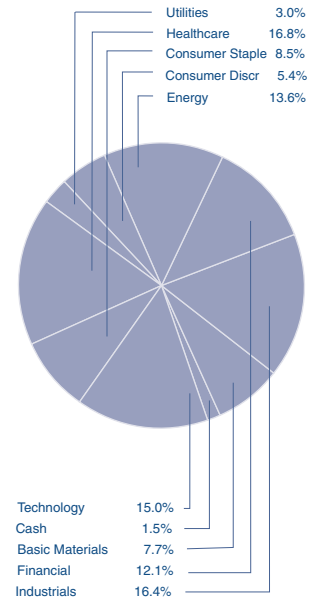
We added The 3M Company (formerly Minnesota Mining and Manufacturing). MMM announced a \$7 billion buyback and beat earnings expectations by 10%. Though this company has threatened to return to the growth track many times only to disappoint, this time investors appear to believe in a sustainable turnaround, as do we. The global presence of the company in an increasingly globalized world may well prove the driver that was needed.

We added Electronic Data Systems; investors don't like it but we do—revenues and earnings are fine, the stock has almost never been this cheap, and we view it as one of the best remaining LBO candidates. When investors pummeled GlaxoSmithKline on controversial news requiring a safety warning for its Avandia drug, we felt it was a moment of irrational fear regarding this stock, which is a sparkler from a dividend-growth perspective. Their pipeline remains strong, and we believe the Avandia crisis is already almost gone, as there are no competing drugs with a better safety profile for diabetics. Also in the health zone we bought Teva Pharmaceuticals at a good entry. Between an MS franchise and outstanding execution in the tough world of generic drugs the company is doing well, and it is priced at the low end of its historical valuation range.

Our selling was mostly profit-taking, making room for our new buys. We continue to like Allstate, Ball Corp, Colgate, Fidelity National Information, and Sigma-Aldrich, but we only want to own them when the appreciation possibilities are higher than any comparable stocks. In the case of National Financial Partners, our other sale, we like the concept and dividend growth, but we began to question their execution capability. In any event, none of our sells was a result of the corporate narrative turning sour, and we may well own these stocks again—at the right price.

**LOOKING FORWARD**

We suspect the overall environment will become fussier, now that the valuation support from twelve months ago has weakened. But there remain enough companies on a prosperity track to interest us, and we have few questions about our current holdings. The growth that tends to feed this portfolio remains present in the domestic and global economies, but now almost any moment contains elevated profit-taking potential, so we may wind up with more cash than normal, at least on a transient basis.



**FUNDAMENTAL CHARACTERISTICS**

<b>Yield</b>	1.5%
<b>Proj Dividend Growth</b>	12%
<b>Payout Ratio</b>	25%
<b>Market Cap</b>	\$48.4 Bil
<b>Price/Book</b>	3.3
<b>P/E Ratio</b>	18.5
<b>S&amp;P Rating</b>	BBB+

(Weighted Averages)

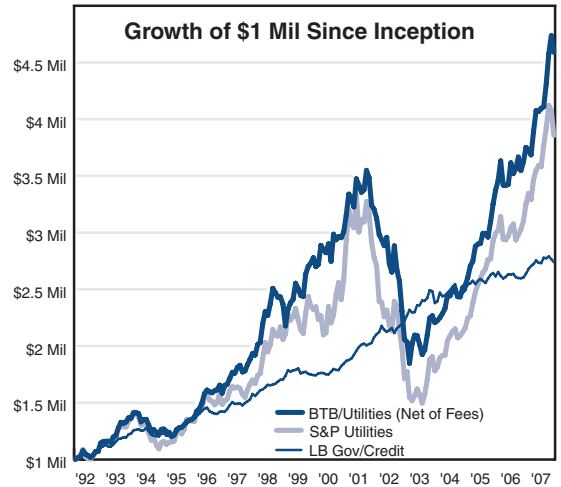
*“It would not be off the mark to think of our strategy as an ‘uncorrelated asset,’ in which investment considerations far overrule index representation or weight in evaluating the individual securities.”*

We’ve been wagging our finger for some time now about rather full valuations in the large-cap electrics, despite fundamental improvements that reduce the comparability of these equities to those of the 1980’s and 90’s. In utter defiance of our admonitions this group (which we generally don’t own but which does set a kind of tone for the sector) raced yet higher on into May. Then nervousness in the bond market, which would not normally have much effect on this sector but for stretched valuations, proved a spark to ignite profit-taking and a quick fall of about 10% in a few weeks. That’s normally not what you’d expect from this historically lower-volatility segment, but that’s what you get when valuations get out of hand and many holders are “generalists.” So most electrics, whether large-caps or not, finished the quarter in negative territory, and in our view enough technical and sentimental damage has been done to set them on the sidelines for a while.

But that did not affect our portfolio very much, and we had an outstandingly positive quarter in yet another example of the lack of correlation our portfolio shows to the general utilities sector, and, frankly, the difficulty of benchmarking it. We display the major indices in our performance tables to provide a picture of the general environment, but our returns are often unrelated. It would not be off the mark to think of our strategy as an “uncorrelated asset,” in which investment considerations far overrule index representation or weight in evaluating the individual securities.

**PORTFOLIO HIGHLIGHTS**

We had very few transactions; existing foreign phone holdings and gas-related companies were the drivers this past quarter. We’ve been favoring foreign phones in recent years since, while they offer the substance and local economic dominance of our domestic companies, service penetration is significantly



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

lower and therefore growth opportunities are substantially better. Obviously this comes with some risks—political, currency, and regulatory, to name three—but we think the appreciation potentials here are sufficient compensation. America Movil, the Latin American wireless company, reported much stronger than expected EBITDA, prompting observers to raise projections for 2007 and 2008 by nearly 20%. The stock responded with a gain of nearly 30%. A potential deal for some or all of Brasil Telecom fell through, but that did not harm the stock, as it also rose about 30%. Turkcell also reported strong results, and the stock gained some 25%, as did China Mobile Ltd, which we consider something like owning AT&T early in the 20<sup>th</sup> century. In hindsight we’d like to have had larger weights in these, but we’ve moderated the weighting here to reflect greater volatility and risk.

Though natural gas prices were not especially strong, our gas-related equities made solid contributions. Questar reported earnings 10% better than expected, and the stock, our heaviest weight, helped lead the portfolio higher, as it has so many times over the years (it has quadrupled since first purchase). Pioneer rose on news of an MLP offering, new addition El

**Quarter Composite Net of Fees\***

BTB/Util*	6.9%
Russell 3000 Utilities	3.4%
S&P Utilities	(0.4)%
LBGC	(0.5)%

**1-Year Composite Net of Fees\***

BTB/Util*	27.2%
Russell 3000 Utilities	29.3%
S&P Utilities	26.0%
LBGC	6.0%

**10-Year Annualized Composite Net of Fees\***

BTB/Util*	9.4%
Russell 3000 Utilities	5.8%
S&P Utilities	8.9%
LBGC	6.1%

\*Preliminary Returns.

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 6/30/07: 149 accounts representing 94% of assets in the strategy, with a dispersion of 0.10. Inception: 9/91.

Paso provided double-digit gains, and midstream companies ONEOK and Southern Union both provided leadership. We swapped Anadarko for GMX Resources and Goodrich, two companies with much faster growth and much lower finding costs (Anadarko’s high finding costs have been bothering us for a while). We can’t say the swap has borne fruit just yet, but we’re confident that it will.

Enablers benefited from a strong market environment outside of utilities as well as their own good fundamentals. Cypress Semiconductor—which we own for its fast-growing solar cell division—rose over 20%, as did Mueller Water (once again, we bemoan low weighting with 20-20 hindsight, but these are more volatile issues). Corning delivered double-digits. We think this company has very large opportunities for growth on many fronts going forward. Qualcomm is a bit mired in patent disputes with Broadcom, but that will work out eventually, and business is very good. We added MEMC Electronics—the leading provider of polysilicon wafers for solar panels (as well as an important supplier to the chip industry), with a modest gain in the initial weeks.

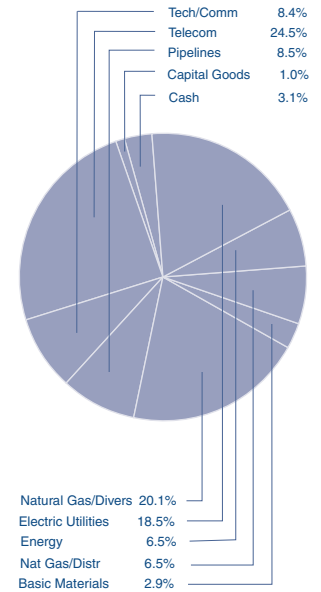
Our electrics were mostly off during the quarter, with sharp profit-taking in Northeast Utilities, and a selloff in NiSource after the company announced that its corporate re-evaluation would result in no action. We still think this is a reasonable takeover candidate, and at current prices the risk is minimal. On a brighter note, Energy East has agreed to be taken over by Iberdrola of Spain for a 26% premium. See our Distribution/Merging Utilities report for more details.

**LOOKING FORWARD**

We expect the headline electric utilities to be dull at best for a while. On the other hand, generators remain well placed and we’ll probably add weight to the independents we

hold. Enablers are coming into their own as alternative energy and conventional infrastructure efforts gain momentum, helped by pending federal and state legislation. Foreign phones can use some pruning at this point, but we have ample opportunities in the sector for re-allocation of capital. Though utilities have led the way in the overall market since the bottom in 2003, there is enough dynamism globally in the sector and its enablers to provide many new up-and-coming or reviving companies that can drive returns in the coming quarters and years. □

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



**FUNDAMENTAL CHARACTERISTICS**

<b>Yield</b>	2.2%
<b>Proj Dividend Growth</b>	7.5%
<b>Payout Ratio</b>	35%
<b>Market Cap</b>	\$31.2 Bil
<b>Price/Book</b>	3.1
<b>P/E Ratio</b>	20.1
<b>S&amp;P Rating</b>	BBB+
<b>Beta*</b>	0.61
<b>R-Squared*</b>	0.42
<b>Standard Deviation</b>	14.1

\*Relative to S&P500, 6/30/97-6/30/07 (Weighted Averages)

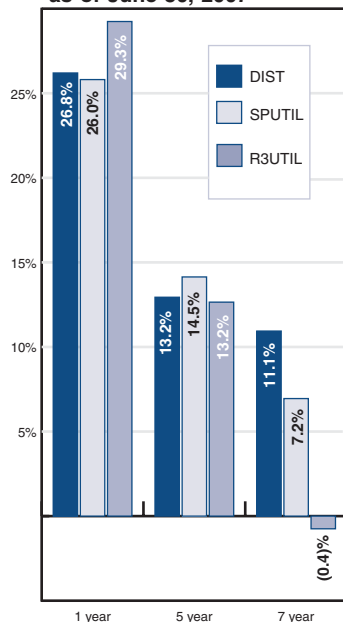
**Annual ADV Update**

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

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

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

Annualized Net of Fee Returns as of June 30, 2007



Quarter Composite Net of Fees\*

Distribution*	2.3%
Russell 3000 Utilities	3.4%
S&P Utilities	(0.4)%
S&P 500	6.3%

1-Year Composite Net of Fees\*

Distribution*	26.8%
Russell 3000 Utilities	29.3%
S&P Utilities	26.0%
S&P 500	20.6%

7-Year Annualized Composite Net of Fees\*

Distribution*	11.1%
Russell 3000 Utilities	(0.4)%
S&P Utilities	7.2%
S&P 500	2.2%

\*Preliminary Returns.

Included are all unrestricted portfolios that have been managed for one full quarter. As of 6/30/07: 226 accounts, representing 96% of total assets managed in the strategy with a dispersion of 0.19. Inception: 1/99.

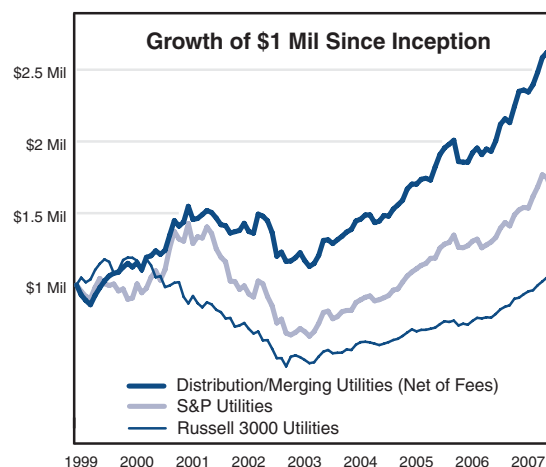
This quarter felt a little bit hellish for utility investors—we’ve suggested for some time that the general group move was unsustainable—and yet when the dust settled at the end of the quarter the index returns were not that negative (thanks to a bubbling-up in April). Considering how well utilities generally have done since 2002, so far there is not much to bemoan. In our portfolio we have 6 straight positive quarters including the one just past, and 11 out of 12 in the past three years—a level we’ll be more than content to repeat.

Nevertheless, the general tone of the sector (marked by a 10% index decline from the end of May through June) provided a notable headwind against which our portfolio had to fight—and it did a credible job, thanks to three takeovers. These weren’t the richest deals we’ve seen, but they still provided premiums as well as continued validation of our strategic premise, after a period slow in deals due to rising prices of the available targets. Just as important, investors were reminded that the consolidation drama still has many plot twists and turns available, and buyers may come from many places—private equity, foreign utilities, or even, as we’ve seen in Europe already, large pension funds.

PORTFOLIO HIGHLIGHTS

The three takeovers in our portfolio this quarter were Alltel (AT)—to which we had returned in the first quarter at what seemed a timely moment—BCE (BCE, formerly Bell Canada Enterprises), and Energy East (EAS).

Alltel was a bit of a surprise, in that it was a private equity deal—we thought it was one of the few remaining likely candidates for acquisition by a major telecom company, as it offered nice growth and an attractive geographical footprint with reduced competition and substantial roaming fees. We’re wondering about the intentions of the new owners, and wondering if it might become a platform for a new national provider down



the road. The deal was modest, but we’re content with a roughly 10% gain in a quarter like the one just past.

Energy East had been a kind of Rodney Dangerfield in this portfolio for a long time, bumbling along at roughly book value in a fantastically strategic set of locations. It had remained no better than stable even as the more glamorous utilities soared on the wind of fund buying. But this portfolio often requires a wide and firmly placed bottom and a well-built chair, for sooner or later the stocks that should be taken over are taken over. Energy East was simply too cheap and too well located to remain independent, considerations which led to our weighting the stock among the highest in our portfolio, even though it wasn’t much of a “performer.” Although the premium of over 25% from recent prices offered by Spanish utility Iberdrola (the same company that bought our Scottish Power earlier this year) was decent, we don’t think it is necessarily pre-emptive. EAS still sells at only a small premium to book, and Iberdrola announced that the acquisition would be immediately accretive. They might as well have announced “there’s more in it” to other potential suitors, such as National Grid, who we frankly thought was the more likely taker. The fact that we can reasonably imagine other bids prompts us to hold on for now. Could the deal fail at the

regulatory level? Two major utility deals came apart due to regulatory demands in the last year, but in these cases regulators were dealing with vertically integrated companies that had some control over pricing, and in both cases the utilities controlled supply for their states, with attendant political volatility. EAS, though, is a distributor, and as yet no deals for distribution companies have failed due to regulatory requirements.

The deal for BCE was announced the day after quarter's end, but we had already registered a notable gain, and this will be rather old news in October, so we report it now. There was a stag line of bidders, built up in a formal and publicly announced auction process. We bought the stock in May, when the buzz was so strong we would have been miserable if we didn't own it, gaining about 12% before the announcement, with another 6-8% to go at the offer price. Two of the bidders, in whole or in part, were Canadian government pension funds, and we find that intriguing. We've always thought that pension funds could meet their actuarial assumptions very smartly by owning a monopoly utility, though we'd reduce the strength of that opinion in the case of a technology-dependent telecom company with potential competition lurking behind every...telephone pole.

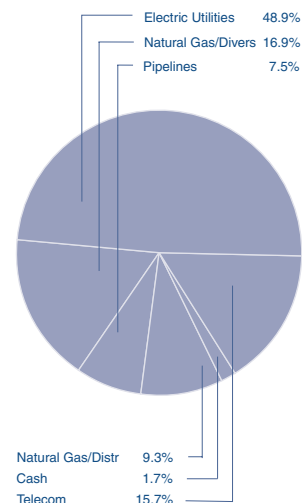
Elsewhere in the portfolio we had good results from stocks with unique characteristics or stories that were not subject to the late-quarter broad-based downdraft, and poor results from those that were. What bucked the trend? Some were companies with merchant operations in natural gas, such as Questar, El Paso, and Energen. Companies with merchant business in electricity generation, including PPL, Edison International, and Black Hills, provided good performance as well. Foreign phone Turkcell rose over 20%, and there were good returns from two stocks with present or future MLP operations, Southern Union and ONEOK. We took some profits in the latter, a stock we've

held for years (proceeds were triple our cost), and took partial profits as well in Dynegy, a turnaround we bought last year at less than half the price.

Dragging down the portfolio were the more conventional names, the vertically integrated types that tend to move with the utility averages. Among the poor performers were Westar, Progress Energy, Scana, Xcel, PNM Energy, and American Electric Power. Northeast Utilities fell double-digits, but this was due to profit-taking from an extraordinary performance in recent years. We were disappointed by NiSource, which announced that after an extensive strategic review they had decided to do nothing. The market was expecting a deal here, and the stock dove 15%. We still expect a deal—their Columbia Pipeline is a crown jewel—and we're sticking with it.

## LOOKING FORWARD

The general utility correction may not be over, and that will weigh on performance, but many stocks have re-entered the value zone so we're more relaxed about the sector in general than we've been lately. We would expect the downward momentum to slow, in any event, and would prefer, actually, some more downside to wash out the "generalist" investors in the sector. It's not as though anything fundamental has changed or gone wrong; prices, as we've pointed out ad nauseum, had simply gotten too rich. While the relationship of utilities to interest rates is something of a myth, a bump up in rates was the match to light the tinder of stretched prices, at this moment, inspiring both profit-taking and irrational flight reactions. We don't expect a return to the races anytime soon, but the tone for buyers should begin to improve from here. And let's not forget how cheap our assets look to holders of the mighty Euro! □



## FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	2.9%
<b>Proj Dividend Growth</b>	6.9%
<b>Payout Ratio</b>	47%
<b>Market Cap</b>	\$11.2 Bil
<b>Price/Book</b>	2.2
<b>P/E Ratio</b>	18.9
<b>S&amp;P Rating</b>	BBB+
<b>Beta*</b>	0.37
<b>R-Squared*</b>	0.16
<b>Standard Deviation</b>	12.9

\*Relative to S&P 500,  
12/31/98 - 6/30/07  
(Weighted Averages)

## Income-Equity Strategy continued from page 5...

left on health care reform won't be an issue, and national demographic trends certainly provide opportunity. Citigroup almost always qualifies as a candidate for our portfolio and, averse to big banks generally, we typically take a pass. However, this company might unlock considerable value with a change of management, and the substantial entrance of a new activist investor persuaded us to include it, at 4% yield, as a modest portfolio position.

## LOOKING FORWARD

At a tenth anniversary the past tends to grab one's attention more than the future. So we reviewed quarterly reports from many years back, and found many variants on the same statement: we continue to seek quality stocks at any capitalization size that offer solid dividends and solid prospects for increasing them—without too much regard for the market. Conditions of the past few years—moderating growth, stable long rates, stable inflation, rivers of cash but dry streambeds of income—are good for us, and we don't see that there has been much change in the underlying economic fundamentals. So we like the stocks we hold, and we are sifting through the rubble of a disastrous quarter for utilities and REITs to uncover new candidates.

The current yield of the portfolio is 5.38%, and our projected growth of yield is currently 9%, so most investors today can expect a 12-month yield that is higher than the stated “current” yield. Indeed, for investors since Jan. 1 of this year, the actual yield is already (in rough numbers) half of one percent higher, due to special dividends and dividend increases. An existing investor has received 3.15% in actual and accrued income for the first six months of the year. We can't predict what will happen on the special dividend front for the remainder of the year, but we do like to remind investors that high as our “current yield” is, historically investors have normally reaped more than that in actual cash flow. □



PO Box 549  
Woodstock, NY 12498

Contact Information:  
Helen Hamada  
helen@mhinvest.com  
www.mhinvest.com  
(888) 282-8845