

MARKET OVERVIEW

THE STRATEGIES

BETTER THAN BONDS / UTILITIES

A bond alternative and moderate equity approach focusing on opportunities in the broad utilities sector: electric, gas, telephone, sanitation and water.

A conservative socially responsible strategy offering growth and income for total return investors.

BETTER THAN BONDS / INCOME

A fixed income alternative which utilizes reliable companies from across the broad market. Stocks are conservative, high quality, high yield, and are projected to have a rising stream of income.

THE SBI PORTFOLIO

A mid-cap strategy combining value with moderate growth that utilizes stable, moderate growth stocks from all sectors and emphasizes companies with strong dividend growth as well as unique fundamental characteristics.

Based on the strategy detailed in Lowell Miller's book,

"The Single Best Investment."

ALPHA-BASED STRATEGY

An aggressive strategy focusing on small and micro-cap stocks using both value and momentum analysis.

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Finally we can stop whining about investor apathy toward real investment value. Last quarter we suggested that the yearlong frustration of being an actual investor—as opposed to a crowd follower or momentum player—carried with it a psychological danger in the potential desire to capitulate to the current winds. It's only when every voice throws in the towel and sings a unified chorus that a bottom and a change occurs. By the end of the first quarter it indeed seemed as though nothing but a nifty-fifty or an index approach would work, and Wall Street's market strategists were busy cranking out justifications for the "new trend" and why it would last indefinitely.

Then, eureka (!), value strongly outperformed growth in April and May, smaller and mid-cap stocks began to develop a head of steam, last year's mutts in emerging markets became this year's thoroughbreds, and active management (including our own) began to move ahead of the hitherto ominously impregnable benchmarks. The inevitable long-term convergence of the returns of various equity types and styles appears to have begun. Even real estate stocks, boosted when Warren Buffet took personal positions in the sector, bounced up smartly after more than a year of merely smarting.

Speaking of Warren Buffet, Berkshire Hathaway's oracle once again weighed in with what struck us as a cogent, concise, and penetrating articulation of the broad nature of investing, in a recent short interview for *Investment News* (6/28/99): "The simple principle of investing is laying out money today to get more money back in the future. The keys to that are predicting the stream of payments you are going to get in the future, and deciding at what interest rate to discount them back to present value. That, 50 years ago, was the situation, and it will be the situation 50 years from now."

"If you are going to evaluate Coca-Cola or Gillette, there is not much additional information you need that was not there 20 or 30 years ago. There is no shortage of information. It's a question of what you do with it in evaluating it in terms of what cash it's going to give you in the future. . . . That's all there is to investing, and that's what investing will be about 50 years from now."

So, yes, the machinations of Alan Greenspan are of interest (though the hour-long and more "specials" we noted on radio and television which were created to hype the breaking news of a ¼ percent rise in the fed funds rate were surely the goofy height of media microscopy), the one or two cents above or below earnings expectations are of interest, the group rotations are of interest, the breakouts, the breakdowns, the revisions, the decisions, the price of oil, the bouncing yen—these things are of interest but not really momentous; they're merely of the moment.

The core of investing is, as Buffet put it, simple. ...It's about owning a share in a company!!!

In the long run, we're not investing in, as Buffet once noted, "bouncing pieces of paper with companies attached to them," but, in fact, in the companies themselves. An awareness and alertness of ongoing developments can help, an awareness of technical factors can help, an awareness of the larger categories of investor behavior can help—but all can help mostly only at the margin. The core of investing is, as Buffet put it, "simple." And, we would add, probably too simple for most of us to grasp (present company excepted, of course). It's not about uncovering the next big thing (though we're always looking). It's not about placing a bet on the pet favorite of some smiling Jack whose PR firm has gotten him a slot on CNBC. It's about owning a share in a company!!!

That said, everyone still wants to know what the crystal ball has to say. Barring extrinsic events such as wars or embargoes or the kinds of global financial turmoil experienced last summer, the key variables are interest rates and earnings. Prices respond to those two issues in proportion to the degree to which investors consider them important at the moment—and one needs to bear in mind that investors can be quite fickle in terms of their level of concern or apathy.

Rates have been surprisingly negative, though looking backward at the persistent strength of the economy this should not have been such a surprise. Still, with the U.S. virtually the only country in the world enjoying palpable prosperity, it indeed has been a surprise that pent-up demand has not been fully met, and the economic machine continues to chug. We didn't think the economy could remain as strong as it's been for as long as it has, but we're not about to argue with a Purchasing Managers Index of 57, which is robust indeed. Instead we'll have to assume a kind of trend-following attitude toward economic growth—that it will continue until there is clear evidence of slowing. At the same time, it is old news that this growth has not produced the inflation that would normally have been expected by classical economic theory. Productivity resulting from computerization, as well as modest labor demands despite a tight job market, have kept inflation at bay. And it is inflation, not the economy per se, which drives interest rates. Looking at inflation alone, bonds actually appear a bargain at current levels (more than 400 basis

points above the inflation rate). Unless the rest of the world can wake up and start kicking, it's hard to see a really substantial move higher—though without a moderating economy investors will surely not push rates lower. As the year moves toward Y2K, we don't believe the world's central banks have any choice other than an easier monetary policy, since they will be loathe to add extra pressure to an already uncertain event.

Earnings have been surprisingly good for the most part, and any change on this front is likely to be both lugubrious and highly evident to even the casual observer. If anything, gradual recoveries in foreign markets are likely to keep earnings buoyant.

Putting these two key elements together, it's difficult to discern either much potential upside or much serious risk in the coming quarter for the major averages. Earnings provide support, but P/E's are already high and this support from earnings is required at current levels. Rates continue to threaten P/E ratios, though we believe the worst of the threat has been seen. Thus, the key elements appear to balance out just now, and only a trading range market can be expected. If there is any major surprise, it will be a recovering bond market (which no one now expects; bond investor sentiment is as negative as we've seen in many years).

Y2K remains a wild card. We believe Y2K will not be a serious real-economy event in this country, but it may produce chaos overseas. How investors will react to the prospect of Y2K is another matter. This aspect is unpredictable, yet the probability of investors anticipating Y2K with a powerful rally seems low indeed. Even with a broad market "ceiling" created by difficult rates and Y2K anticipation in sight, however, we continue to find many fine values beached by the nifty-fifty tide of the past couple of years, and see little long-term risk in these investments. "Stock picking" opportunities will persist for the second half of 1999 and beyond, even in the context of what is likely to be a choppy environment. □

Lowell G. Miller
Chief Investment Officer

SELECTED INDICES

	2 nd Qtr'99	12 Mo
S&P 500	7.05	22.76
Equity Inc	9.23	11.36
Util Fund	9.30	15.60
DJUA	9.35	11.84
LB Treas	-2.48	-0.26
LBGC	-1.10	2.70
S&P 400	14.16	17.19
Val Line	13.81	-2.29
Rus 2000	15.55	1.50

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

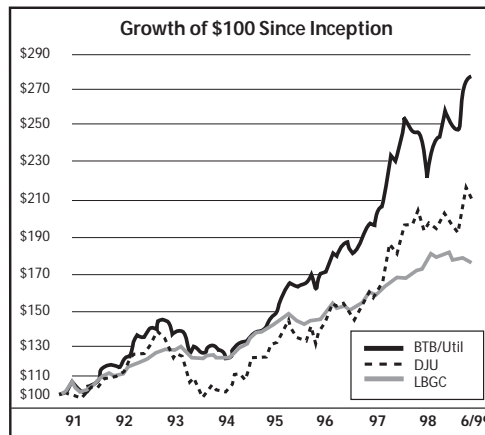
It's always pleasant when one's crystal ball glitters and glows. Last quarter we suggested that "there are only three things certain in this world: death, taxes, and the recovery of utilities after a price decline." And we thought that the more traditional utilities in our portfolio, such as gas distributors and mid-cap electric companies would lead the recovery—rather than the more aggressive phone companies. All this is seen as part of a "return to normalcy" which has been slowly, grudgingly, kicking and struggling its way back into the marketplace since last October.

This time our speculations proved pointed, as we experienced one of our best quarters ever, characterized by broad participation across the portfolio, leadership from traditional utilities, and no bad dogs. Notably, this performance occurred in the face of a continuing rout in the bond market (the Lehman Bros. Long-Term Treasury Index is down -6.65% for the year to date). We can now bang the gavel: let no one ever again rhetorically inquire—"utilities trade kind of like bonds, don't they?"

We've been noting for several years the frequent unshackling of utility price movements from movements in the bond market (at least for the kinds of utilities we own). If there was any doubt as to the sustainability of this divergence, the magnitude of 2Q1999 performance must surely shame any remaining skeptics. While we'd never pronounce our stocks *immune* to rate movements (since all equities are affected by the competitive investment appeal of debt at various times) this emerging freedom from bond pricing is a lovely development from a number of perspectives.

Clearly, it is attractive for investors to have an income-oriented investment that isn't attached at the navel to bonds. Bond mathematics are cruel for the investor interested in current income: rates go up and bonds go down. Now, in addition to the higher returns we've always provided, we can look forward to at least partial escape from the iron rule of rates and prices. Our strategy becomes more

attractive in an asset-allocation, since the correlation with bonds, never that much stronger than the correlation exhibited by stocks in general, has weakened. And "the disconnect" augurs well for our future relative returns, since we've almost always outperformed fixed income in a ris-



ing market and felt the heat of competition only during negative times. All in all, our position as "better than" is likely to be enhanced.

For the trailing twelve months we're back above all relevant benchmarks (now that the distortions of 1998 have been wrung out of the bond and large-cap electric markets) with a net return of 12.56%. And we continue to perform better on a twelve month basis than nearly all more remote indices, such as Convertible Bonds, Balanced, Equity Income, and the average of all mutual funds. For the trailing five years our net returns of 17.64% are far better than the fixed income indices and both the "all funds" and the "equity funds" averages, and are better or competitive with every category of mutual fund save Index and Large-Cap Growth.

Despite much more modest valuations and lower volatility than other types of equities, our portfolio has remained right in the thick of it throughout this bull market, generating returns comparable to much riskier strategies while still providing substantial current income for

We can now bang the gavel: let no one ever again rhetorically inquire—"utilities trade kind of like bonds, don't they?"

Quarter Composite Net of Fees*

BTB/Util (Preliminary)	12.15%
DJUA (total return)*	9.35%
LBGC*	-1.10%
Ave Util Fund	9.30%

*Index returns are stated gross of fees, although it is not possible for an investor to purchase the index without incurring fees.

While we are primarily concerned with eternal verities in our investing, let it never be heard from us that the world does not change!

our investors. More to the point, as the millennium approaches we can note that a goodly number of our companies were around for the *previous millennium* celebration—a simpler time, when men were men and bugs were non-virtual.

PORTFOLIO HIGHLIGHTS

Consolidation and electric-gas convergence in the utility industry remain the primary by-products of reduced regulation, and these twin trends continue to exert a salutary effect on our portfolio. Indeed, as was the case in the first quarter, consolidation plus broad diversification across the industries of the sector helped us toward our solid returns.

Two deal stocks that at first appeared to provide only modest gains for the portfolio in the first quarter blossomed in the second, as investors began to take the deals more seriously and to perceive the benefits of the new combinations. Last quarter we noted that the takeover of **Consolidated Natural Gas** by **Dominion Resources** was “not a rich deal for us, but remains an interesting holding with almost 20% upside . . .” In fact we’re at somewhat of a loss to understand why the stock didn’t trade closer to the takeover price immediately, but the end of the story is that shareholders of both companies have approved the deal, as have nearly all relevant regulators, and that “20%” showed up for us on cue. Since Dominion is a nuclear operator we won’t be holding shares in the new entity, but CNG has been a good long-term holding for us, boosted, you may recall, by a doubling of our position last August when panicking investors handed stock over at a remarkable \$42.

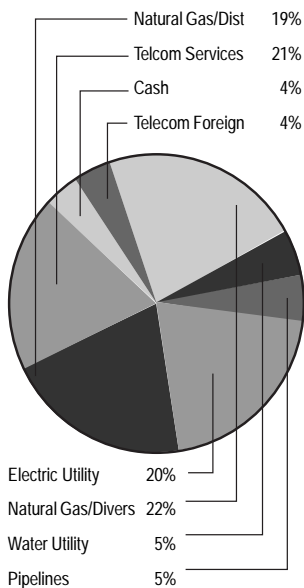
The takeover of **Sonat** by our holding **El Paso Energy** also failed to inspire investors last quarter when it occurred, and we had to suffer some downside in EPG as arbitrageurs pushed the acquirer down. But energy pricing remained firm and the synergies between the two companies transportation operations became clearer to investors, prompting a 40% upward revaluation of Sonat shares from 25 to 35, though EPG merely moved back to its pre-deal pricing. We trimmed EPG so that the combined position would not carry so large a weight in the portfolio.

We’re also a bit higher for the quarter in earlier deal stock **Frontier**, which has now been joined by our holdings in **US West** as the glint in the eye of both **Global**

Crossing and **Qwest**. While we are primarily concerned with eternal verities in our investing, let it never be heard from us that the world does not change! Global Crossing is about two years old, Qwest is not a great deal older. Yet these two companies have the cash flow and currency to bid for two of the most venerable names in telecommunications. While there’s a news story every day on this boiling pot, and as of this writing no one can say who will prevail (we’d prefer the more substantial Qwest to emerge victorious, and have taken something off the table with a reduced weight in previously top-weighted Frontier), what’s most interesting about this tale is what it says about utility transactions in today’s world.

Both Global Crossing and Qwest are basically equivalent to manufacturers and wholesalers in the fungible business world. They manufacture fiberoptic lines around the country and around the world, and wholesale space on those lines to telecommunications service companies (as well as some business customers). They are not primarily “service companies” themselves—they don’t deal with the ultimate user of their facilities—but they want to buy service companies, even service companies that some would consider less than premium merchandise. Why?

Simply put, they want to own customers. Scale and distribution, or both, has been the theme of utility consolidations to date, but distribution capability is increasingly the motivation of the transactions that are being announced. We have thought for some time, and the current trends seem to confirm, that Marx was wrong once again. Power resides not in control of the means of production, as the founder of Socialism suggested, but in control of the means of distribution. Just ask Wal-Mart or Home Depot, or Coca Cola. This is why AT&T is buying cable, this is why so many gas distribution companies have been bought and most of the rest will be, why SBC bought Ameritech, why Bell Atlantic bought GTE, why Travelers bought Citicorp, why smaller banks are just so many items on the shelves awaiting a bigger buyer. The buyers want to own customers, because it is much easier to retain a customer than to find a new one. If you can buy a customer, you’re likely to keep him or her. And if you don’t buy that customer, you’ll spend a lot trying to gain him, with a reasonable chance of failure. If you do own lots of



customers, you might be able to sell them more and more kinds of goods or services, just as Wal-Mart has done. Plus there are clearly economies of scale in any distribution business.

And that's what makes distribution deals so attractive in an age of reduced regulation for utilities. The company that is the connection point to the customer, the company that "owns" the customer, that *sends the bill*, has a wide open field for potential growth with limited risk. If you are a gas distribution company, for example, you still have a geographical monopoly, with a regulated rate of return on the business of transporting gas from various producers and marketers to the end user. But you also have a great asset in your mass of customers, who've come to know and trust you. They might buy heating equipment from you, or maintenance and service. They might buy security services, or telecom services, or cable, or even grocery delivery. Your cash flow base is secure due to your monopoly business, and your opportunities for growth are as large as your management ability can generate. No one else has this opportunity, because no one else sends the bill. Whatever you can add to the menu is your chance for growth, and if you add nothing you still get the regulated rate of return on your investment.

Sound like a good deal? We think so, and that is why we're so heavily committed to distribution utilities. Those that are too small or too weak will get purchased, and those that grow strong through purchase will come to dominate their markets and sell goods and services in increasing scale to their proliferating customers. We also think that investors in general have overlooked and underestimated the potentials in this area. The stocks remain, as a group, much cheaper than their private market values. Most offer yields of 4% and up. They are still perceived as grandpa's income stocks, but we think they will be that and much more in the years to come.

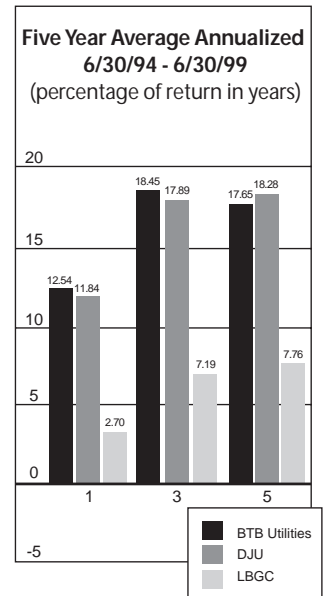
WICOR received an offer from **Wisconsin Energy** just at the end of the quarter, for a 35% quarterly gain that's right in line with our valuation formula for distribution utilities, based on the numerous transactions that have occurred over the past year. Pipeline and distributor **KN Energy's** deal with **Sempra** collapsed at the end of the quarter, with investors selling the stock down to three-quarters of book value. We bought what they sold. Now, as we

write, a deal between KNE and portfolio stock **Kinder Morgan** has just been announced—and KN now sports a 50% gain over our two-week holding period. There are many more opportunities for consolidation in our portfolio, and these stocks, traditional utilities as it were, were also leaders in our rally this past quarter. Companies like **MCN**, **TECO**, **Eastern Fuel**, **MDU**, **Questar**, **Keyspan**, are all bait for a bigger fish, and all are interesting solid holdings in their own right, with no real transaction premium built into their prices. It's no wonder we have a spring in our step.

Apart from the deal arena, we added **Azurix** to the portfolio. What's an Azurix? It's the water division of **Enron**, just gone public, run by a woman who was responsible for Enron's successful push to develop internationally. Azurix will be a global consolidator of water companies and a service provider to existing water systems, and has already established an impressive growth track record—albeit one that's short by our standards. But we consider this an addition to our Enron holding, rather than a "new" name.

LOOKING FORWARD

In most cases we wouldn't expect a comparable encore to our recent big quarter, since such moves tend to produce lots of overbought stocks vulnerable to short-term profit-taking. But as we review the portfolio now, we don't really see evidence of that kind of blight. Our issues that are way up are involved in transactions that are unlikely to fail, and the rest remain at reasonable pricing levels despite the quarter's gains. So, while a repeat probably isn't in the cards, there's a good chance that further positive returns are in the offing for the near term. Our stocks remain the most modestly priced, reliable, and among the highest yielding in the market. In a time when investors have once again begun to seek out true investment values, these facts can hardly be ignored. Traditional utilities are still positioned to do well, we have an ample supply of transaction candidates, and there are plenty of possibilities for new names (we're homing in on a possible replacement for **AirTouch**). As noted in the overview, there's a reasonable chance of an upside surprise in the bond market, and a bond rally would probably boost returns, even though we've been immune this year to the bond declines. □



UTILITIES PORTFOLIO CHARACTERISTICS

Beta*	0.64
Dividend Payout	61%
Sharpe Ratio	1.20
Projected Dividend Growth	4.6%
Treynor Ratio*	19.34
Current Yield	4.5%
Annualized STD	10.34
Market Cap (MDN)	\$3.9 Bil
Price/Book	2.50
Quality	B++
P/E Ratio (MDN)	16.91

*Relative to DJUA, 6/30/94-6/30/99

...it's comforting to know that a bear market in bonds does not necessarily induce weakness in our total returns.

We were overly optimistic about the course of interest rates for the quarter in our last report, but not about the prospects for the BTB/Income portfolio. As investors in equities came to realize that there is more to life than large-cap indices (index funds were among the worst performers) the dormant values in our portfolio began to receive some recognition. While we always hope for good returns, greatest satisfaction for us comes from being “better than bonds,” and this quarter and year to date have offered a performance spread as great as one could hope for. Our current yield is comparable to long-term bonds, and yet our returns are solidly positive (better than the S&P 500, in fact, for both quarter and year-to-date). While we can't propose that our high-yielding stocks will always be able to rise when bonds are declining, it's comforting to know that a bear market in bonds does not necessarily induce weakness in our total returns.

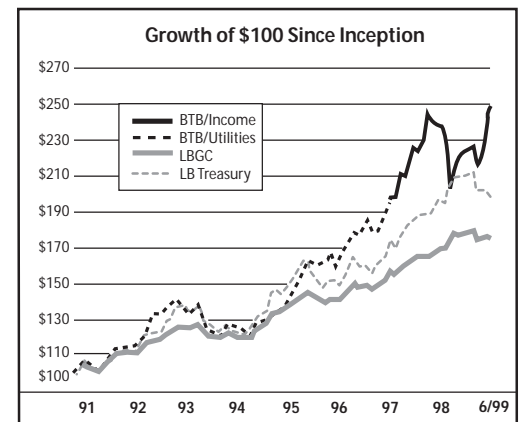
As was the case with BTB/Utilities, there were really no problem stocks in the portfolio. Outstanding returns were seen from issues in the utility sector, including gains of about 15% or better from Equitable Resources, MCN, Peoples Energy, Cinergy, TECO, and Frontier. But REITs also contributed (at last!) as did forest products and our industrial stocks. Both newer and older holdings played a role.

For the quarter our (net of fees) return was 10.96%, giving us a year-to-date gain of 10.07%. For the trailing twelve months our return was 4.10%—a seemingly modest number but well ahead of our fixed income benchmarks, including the Long Treasury Index which provided a negative total return. The distortions of 1998 appear well behind us, and our longer-term returns continue to pull away from fixed income by a substantial margin. And this is as it should be, for though our yield is high our strategy also incorporates growth of income and price growth of the companies in which we invest, whereas the bond arena is “fixed” in every sense of the word. The stocks in our

portfolio have continued to make fundamental progress, and continue to represent fine value for investors content with a “tortoise” approach—one that may appear unexciting but which persists over time, and accumulates.

PORTFOLIO HIGHLIGHTS

Last quarter we spent some time discussing **J.C. Penney**, which represents the deep value (as contrasted to the dividend growth) area of our portfolio, pointing out that although the company's retail operations were not



exactly dazzling, the embedded value of Penney's drug operations was being ignored by the market, and could justify much higher prices for the equity—and offered a 5% yield while we awaited broader recognition. The wait did not try our patience, as subsequent media pieces discussed the company's strong asset value and investors bid the stock up 20% for the quarter. We still think that a split-up company, or a company with improved retail operations is worth at least in the mid-60's, so we continue to hold.

Expertise in the telecom industry helped us take an opportunistic position in **US West (USW)** when the marketplace reacted irrationally to an offer by **Global Crossing (GBLX)** to buy the company. At the initiation of the offer there was no collar on the value of the GBLX stock; when the acquirer began to drop, investors bailed out of

Quarter Composite Net of Fees*

BTB/Income(Preliminary)	10.96%
LBGC	-1.10%
LB Long Treasury Index*	-2.48%

12 Mo Composite Net of Fees*

BTB/Income	4.01%
LBGC	2.70%
LB Long Treasury Index*	-0.26%

*See Performance Disclosure on back page. Index returns are stated gross of fees, although it is not possible for an investor to purchase the index without incurring fees.

UW West. However, the offer was soon revised to include an adjustment of shares in the event of a Global Crossing price decline. This appeared to make no impact on investors, as USW languished at a price *below* where it has traded *prior* to the takeover offer. While this was not a lovely deal, USW at 52 was too appealing to pass up, given the good possibilities of the deal working or another one coming along. Indeed another offer from Qwest has materialized, at a higher price, and we wouldn't be surprised if there turns out to be other suitors in the wings. This special situation fits particularly well into our income portfolio because not only did USW at purchase carry a current yield above 4%, in addition, part of the GBLX deal includes special dividend payments to USW shareholders which amount to a projected dividend yield of more about 7% for the period ranging from offer to contemplated consummation. It now appears that we will receive in the neighborhood of 30% premium for our stock, which makes the 37% total return just about as good as we can hope for in this portfolio.

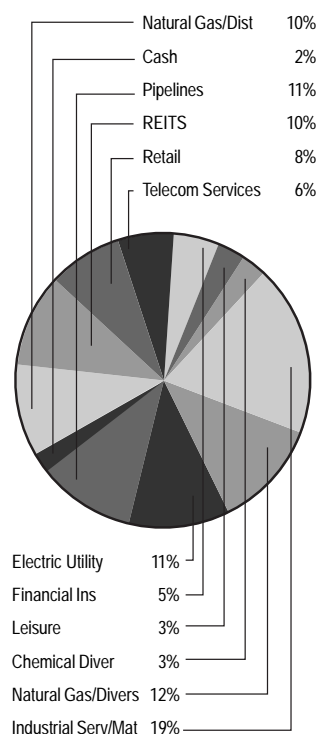
In a more prosaic vein we bought **Armstrong World (ACK)** as a combined value/dividend growth idea. Despite a nearly impeccable long-term growth record as the dominant company in the residential floor covering market, and despite a booming market in new housing and re-sales, ACK hasn't been able to find any friends lately. While it is true that trends have shifted from linoleum and tile to wood in the floor covering industry, not only is there still a big market for these products, but ACK has responded through the purchase of wood products manufacturer Triangle Pacific—whose products ACK can move through its existing distribution channels. Here's a stock with historic growth above 20%, pessimistically projected growth in the low teens, industry dominance, rising earnings and dividends since 1991, top-rated financials, and—you should be sitting down when you read this—a P/E ratio of less than 8 times next year's earnings. There is, in the venerable phrase of Benjamin Graham, a "margin of

safety" in case things don't go as expected. At purchase we gained a 4.5% yield with 7-10% projected dividend growth, and the stock has risen 10% already, so it will be easy to be patient.

We also bought **K-Mart convertible preferred** during the quarter, acquiring a 6.7% yield on an issue that we believe has good transaction possibilities, and which is well into a long-term turnaround in any event. It's not the shiniest car on the road, but it is cheap enough, with great mall assets and a franchise, and contributes to raising our current yield.

Looking Forward

Last quarter we thought there was not much more downside in bonds, and that a stabilization or rally would be helpful. As it turned out there was more bond damage to be done, but we still view the environment similarly. An interest rate surprise is more likely to provide a decline in rates than an increase, and any increases that do eventually ought to be mild. In general this is a good environment for our stocks, and we will busy ourselves seeking replacements for issues involved in corporate transactions. Current yield on this portfolio is 5.75%. □



FUNDAMENTAL CHARACTERISTICS

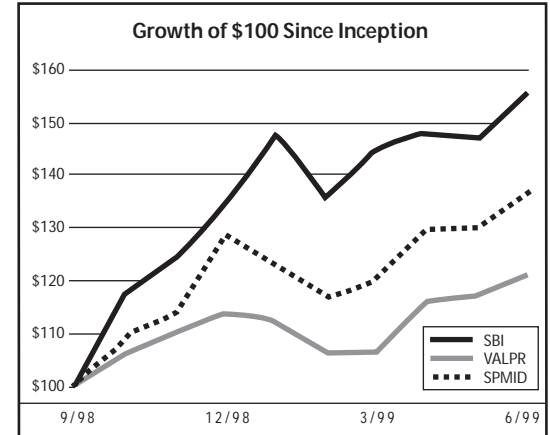
Yield	6%
Proj Div Gro	4.19%
Payout Ratio	68%
Market Cap (MDN)	\$1.5 Bill
Price/Book	2.79
Beta*	0.34
P/E Ratio**(MDN)	14.50
Quality	B+

*Relative to LBGC, 6/30/98-6/30/99
 **Reit's use P/FFO ratio rather than P/E Ratio

Over time, the steady increases in dividends place upward pressure on the stock prices, in a kind of reversal of the slow and steady effects of inflation.

As we projected in our last report, this quarter we completed a transition from the previous Special Values portfolio to “SBI,” which is a portfolio more purely based on Lowell Miller’s new book, *The Single Best Investment* (AdamsMedia, 1999). The primary difference is a reduced concern with current yield—since we offer other portfolios with high current yield—and an increased focus on dividend growth as a signal from management regarding the future prospects of a company. There are a few exceptional stocks in the portfolio, stocks with either compelling stories or radically low valuations, but the core holding here are stocks offering reliable and consistent growth (if not the highest growth available) with a past and projected future characterized by above-average dividend growth. They are financially strong companies with proven markets, stocks that should be easy to hold during times of turbulence and easy to buy when prices decline. They are the survivors of the world, the seasoned managements, companies in which we can take the position of long-term partners, and which we can enter at reasonable if not always bargain prices.

Over time, the steady increases in dividends place upward pressure on the stock prices, in a kind of reversal of the slow and steady effects of inflation. And, more than any other single factor, we believe we can rely on the reality of dividend increases as a kind of litmus test for the degree of prosperity a company is experiencing. No analyst report, no upgrade or downgrade, no media story, no CEO interview, no hype, no tip, no odd price change, will ever be as astute at summing up the whole picture of a stock than its dividend history. Obviously, there are plenty of good companies that don’t pay dividends. We may hold a few of these from time to time for reasons that are consistent with our basic philosophy, but otherwise we have to leave investment in those companies to others. We want to master our “little” corner of the world, and generate long-term compounding from stocks that we understand. Stocks



where we would be happy and tranquil if we owned the entire business.

While we’re not benchmark obsessed (if you own a building on Park Avenue how much should you really care about the prices on Lexington?), we’re using the S&P Midcap 400 and the Value Line Index, which will show at least the tone of the marketplace in the universe from which we select our issues. There are and will be stocks ranging in size from small to mega-cap, but the average capitalization size falls in the middle zone, as do the majority of the stocks. Most positions will start at 3% weight; more if we have an especially high confidence level or we’re able to take advantage of an irrational price decline, less if the stock is riskier.

In keeping with the renewal of investor interest in real companies and real values, our returns were solid this quarter. Our gain of 7.49% reflects a blending of existing SBI accounts and the newly harmonized former Special Values accounts. Commencing with the first SBI portfolios which began at the end of September 1998, our cumulative net return has been 55.49%, versus 37.0% for the S&P Midcap 400 and 21.54% for the Value Line Composite.

PORTFOLIO HIGHLIGHTS

As was the case with our other portfolios, there weren’t many stocks to complain about this quarter, though

Quarter Composite Net of Fees*

SBI	7.49%
S&P 400Midcap	14.16%
Value Line Index	13.81%

YTD Composite Net of Fees*

SBI	15.34%
S&P 400 Mid-cap	6.88%
Value Line Index	6.54%

Fannie Mae and our other financials underperformed, in line with a weak bond market. Still, financial stocks with special stories were able to help out: **Sallie Mae** rose 10% on congressional moves which help insure its future prosperity, and takeover candidate **Summit Bancorp** improved after a slow first quarter. **Rite Aid**, which we cited as deeply undervalued in our last report, showed nothing, finishing slightly down, as the company has much work to do to restore credibility on Wall Street. In the meantime company revenues are soaring. If, as, and when this revenue growth hits the bottom line this stock is likely to prove rewarding.

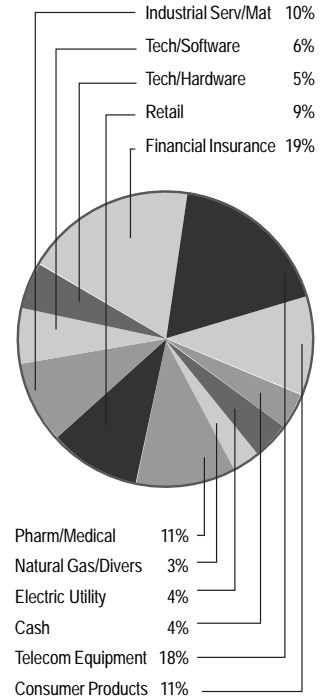
“Borrowed” stocks did well for us. **MCN** from the utility portfolio rose 29%, and **TECO** added 15%, both in addition to strong dividends. **J.C. Penney** from the income portfolio rose some 20%, as did **Timken**, also from the income portfolio. Some new additions led the way, including **Tyco** and **Alza**, the latter of which is being acquired by **Abbott Labs**—which itself is an almost perfect example of an SBI stock (so we’re in the happy position of gaining ABT stock at a roughly 35% discount). The Alza buy was greeted by the Abbott offer within weeks, but for us the best thing about buying Alza was that the stock was the proactive idea of Julia Burhans, assistant portfolio manager for this strategy. After several years of training in triple-A, it is as if she hit a grand slam in her first major league at-bat. We’ve told her we expect all subsequent research conclusions to be equally astute.

Other highlights for the quarter include a massive recovery in price by **Computer Associates** after yet another of its string of better-than-expected quarters, a move up from irrational lows by special situation **Loral**, and mid-teens returns from **Ralston** and **Xerox**. We also added a position in special situation **Rambus**, which is about as similar in look and feel to **Qualcomm** (which we recently sold from the original SBI accounts) as any stock we can find. This one might be a trade—we hold it day-to-day rather than as our normal long-term commitment.

New stocks include **Heinz** and **Lehman**. The first is of course a great SBI dividend-growth name which we were able to add on temporary price softness. It’s not exactly a utility, but we do know many people who would find it impossible to live without ketchup. We relish the thought, as Buffet put it, of the cash back we’re going to receive (or the company will re-invest) over the next 50 years. Lehman consistently surprises analysts with its earnings, and recently raised its dividend by 20%, implying to us that it may well have a few more surprises ready to spring. In addition to doing well, Lehman is one of the few remaining independent institutional investment banks. European banks and insurance companies are scouring the world for expansion opportunities. In this country the Glass-Steagall prohibitions against bank/broker/insurance company cross ownership are about to come tumbling down. We ask ourselves, “how long is an independent Wall Street firm likely to stay independent in a world of acquisitive financial behemoths run amuck as regulation ends?” And we answer without much hesitation, “not long.”

LOOKING FORWARD

In line with our overview comments, given the crosscurrents in the markets and the world, it’s tough to see any big market rally absent a major decline in interest rates this quarter. But the shelves are still stocked with attractive merchandise, in our view, and the long-term values we hold give us a feeling of security and substantiality even in a world of day-trading novices and on-line hype artists. The stocks in this portfolio aren’t exactly tortoises in the sense that the BTB portfolio securities are, but we think their shells are hard and they will get where they (and we) are trying to go, over time. □



FUNDAMENTAL CHARACTERISTICS

Yield	1.83%
Proj Div Gro	9.59%
Payout Ratio	38%
Market Cap (MDN)	\$8.8 Bill
Price/Book	5.56
P/E Ratio**(MDN)	19.48
Quality	B++
Beta*	0.69
STD	23.35
Sharpe Ratio	3.25
Treynor Ratio*	109.8

*Relative to S&P 400 Midcap Index
9/30/98-6/30/99

...more than at any time in the past three years, it seems the portents are all lining up to the positive.

As we noted in the overview, the second quarter of 1999 brought the broad market one small step closer to rationality. It was a period of normalization or equalization in which the best performers of the first quarter lagged while the worst first-quarter performers came to life.

It was a good quarter for our Alpha-Based Strategy. We achieved a gain of 18.04% (net of fees) for the three months, outperforming our benchmark, the Russell 2000, which gained 15.55%. This was the fifth quarter out of the last six in which our value-based momentum investing outperformed the benchmark.

For the first half, our return of 4.03% trailed a 9.28% advance by the Russell 2000 Index. We note, however, that the Russell 2000 has benefited significantly in 1999 from several large Internet issues that had ceased to be small-cap stocks during the course of the past year but were included in the index until last month. Our year to date results were more in line with the 5.04% gain of the S&P Small-Cap Index.

On a trailing 12-month basis, which includes two very weak quarters, our composite of all accounts has produced a respectable gain of 13.84% (net of fees) compared with a small gain by the Russell 2000 of 1.5% and a loss by the S&P Small-Cap Index (-2.31%). Since the start of 1998, we've added 55.1% to the value of our managed accounts compared to 6.5% for the Russell 2000 during those same 18 months, on a cumulative basis. On an annualized basis, our two-year composite return is 34.49% versus 8.74% for the Russell 2000; as we progress through our third year we hope the "spread" will remain as large. In a sense, we've made a silk purse out of a sow's ear recently (though the Russell 2000 was fairly silky this past quarter). And these returns are despite the fact that our value-oriented discipline kept us out of the market's hottest sector (Internet stocks) during the period.

We're looking forward to a persistence of recent superior relative performance by small-cap and micro-cap

stocks. We've done very well when times have been difficult, and have had to be content to merely imagine what it will be like when times are "easy" for our area. But more than at any time in the past three years, it seems the portents are all lining up to the positive. We are off to a great start in July, adding more than 3.5% to portfolio values during the first week of the quarter while the Russell 2000 is essentially unchanged.

PORTFOLIO CHANGES

We had many oars pulling rather than any really big winners during the latest quarter. **Concord Camera (LENS)**, which has consistently been an overweighted position, advanced just over 30% during the quarter. We took a trading profit of about 25% in **Rush Enterprises**

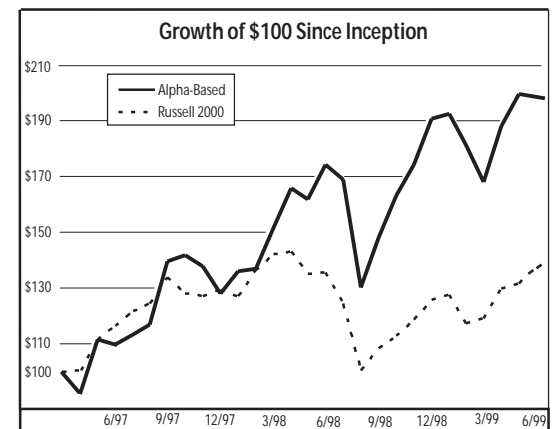
Quarter Composite Net of Fees*

Alpha-Based	18.04%
Russell 2000	15.55%

12 Month Composite Net of Fees*

Alpha-Based	13.84%
Russell 2000	1.50%

*See Performance Disclosure on back page



(RUSH) in April. Also in April, we sold **Garden Fresh Restaurants (LTUS)** at an average price more than 15% above the level at which it started the quarter. RUSH and LTUS had both been heavily overweighted as of March 31st.

Chico's FAS (CHCS), one of our success stories in 1998, contributed to our successful second quarter. Only a few days into April, we sold the stock for 35% more than we paid for it on our latest purchase and 20% above its March 31st price. **American Woodmark (AMWD)** likewise was sold in April for 43% more than our purchase

price and 18% above the level at which it started the quarter.

We caught **Monaco Coach (MNC)** for a very profitable trade in May, and also **Audiovox (VOX)**, which closed the quarter 55% above our May purchase price. One week into July, VOX is trading almost 90% above our buy price.

Biggest disappointments in the quarter were in two overweighted positions, **INTERLINQ Software (INLQ)** and **Javelin Systems (JVLN)**. Javelin ended the period unchanged in price on word that second-quarter revenues would be below plan (though earnings are expected to meet estimates). INTERLINQ declined about 15% when its proposed buyout at a price of \$9.25 a share was terminated (a very favorable long-term development in my judgment).

There is a pattern developing here. We fared very well in April and early May because most of our companies were reporting earnings within that time frame. The stocks rose in reaction to results that typically beat expectations. In some cases, the stocks rose in anticipation of the good news. All our gains for the quarter were achieved in the first two months. However, the “staying power” of good news has not been impressive for small caps lately. June was a disappointing month—just as March had been.

Increasingly, we’re using good news as an opportunity to take trading profits. Although these stocks typically offer superb value and long-term reward-risk ratios when sold, that doesn’t seem to keep them from drifting lower once the bullish quarterly results have begun to fade from public consciousness.

LOOKING FORWARD

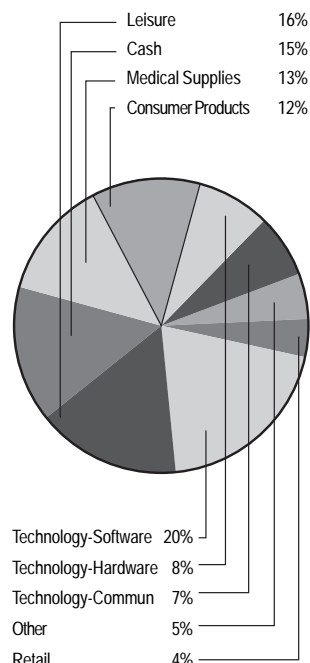
Investors with most of their money in an index fund, might now find themselves having trouble sleeping at night. Even though the economic picture couldn’t be more bullish, most blue-chip stocks could shed 20% or more of their value and still be expensive by historical norms.

But with the economy rolling along and inflation not yet a major threat, earnings growth averaging more than 25% should drive our undervalued stocks higher. The valuation dichotomy between large-cap and small-cap equities remains near historical extremes even after the very modest narrowing of the gap in the past three months. In our view, value always prevails in the long run so small-cap stocks have a reasonable certainty to outperform the blue chips during the next three to five years. And, if we can just amplify those gains with some expansion of valuation ratios from the rock-bottom levels now in evidence, the possibilities are breathtaking. A simple return to historical norms of valuation for our kinds of stocks could easily generate annual rates of return in the range of 50% to 100%. It seems outrageous, but that’s how far out of favor small stocks in general have become. We can hardly wait to exploit the opportunities once the investment winds have fully shifted and are at our back.

Bill Chidester

Portfolio Manager

Note: this past quarter we initiated an Alpha-Based portfolio using *small-cap* stocks in addition to micro-caps. It uses the same philosophy and the same techniques but the universe increases to a cap size up to approximately \$1.5 billion. Initial results have been just as good as the micro-cap group—we’ll keep you posted on our progress as we go along.



FUNDAMENTAL CHARACTERISTICS

P/E Ratio (MDN)	13.57
Market Cap (MDN)	\$60 Mil
Price/Book	3.03
LT Debt Ratio	19.59
Beta*	1.06
R-SQR*	0.60
Annualized STD	29.96
Alpha*	26.00

*Relative to the R2000, 6/30/97-6/30/99

Net of Fees Performance Disclosure

Yield-Oriented Portfolios: Gross of fees performance is based on actual results according to standards set forth by the Association for Investment Management and Research (AIMR). Miller/Howard Investments has prepared all performance results. AIMR was not involved in the preparation or reporting of these results. Net of fees performance is calculated by deducting a weighted average annual fee of 75 basis points from gross of fees performance. A complete list of all the firm's composites is available. Portfolios are matched across all accounts so that each client holds substantially the same issues at the same weights. Portfolios are typically fully invested, and hold minimal cash although cash holdings may fluctuate somewhat on a residual or transitional basis. No representation is made that future returns will approximate past results, and none should be implied.

Better Than Bonds/Utilities: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 6/30/99 was 103, which represents 48% of total assets managed in this strategy with a measure of dispersion of 0.27. Inception of the composite was 9/30/91.

Better Than Bonds/Income: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 6/30/99 was 14, which represents 81% of total assets managed in this strategy with a measure of dispersion of 0.61. The cumulative chart contains a combination of Better Than Bonds/Utilities performance from 9/30/91 through 9/30/97 and Better Than Bonds/Income performance from 9/30/97 through 6/30/99. Better Than Bonds/Income as a stand alone strategy started in May of 1997. BTB/Income is a strategy that evolved from BTB/Utilities sharing the same philosophy and process and many of the same stocks. The essential difference between the two is that a portion of BTB/Utilities invests in Telecom stocks and a comparable portion of BTB/Income invests across the broad market.

SBI: Included in the results are all portfolios, including one non-fee paying portfolio, that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 6/30/99 was 7, which represents 81% of total assets managed in this strategy with a measure of dispersion of 3.26. Note: There is a large dispersion of returns due to the conversion of accounts that were previously included in the Special Values strategy that are now included in the new SBI strategy. These accounts did not contain two substantial portfolio positions, Qualcomm and Quest, that significantly outperformed since the inception (9/30/98) of the SBI composite. We expect going forward a more normal and modest dispersion, as has been our history.

The Alpha-Based Strategy: Gross of fees performance is calculated according to standards set forth by the Association for Investment Management and Research (AIMR). Net of fees performance is based on actual results after the deduction of management fees (weighted average fee of 200 basis points). Included in the results are all Alpha-Based portfolios that are unrestricted, including one non-fee paying portfolio, and that have been managed for at least one full quarter. In addition, in order to be included in the composite a new account has to be at least 80% invested and it should hold not more than 5% cash exceeding the maximum cash held by any portfolio already in the composite, as of the end of preceding quarter. The number of accounts in the composite as of 6/30/99 was 17, which represent 42% of total assets managed in this strategy with a measure of dispersion of 0.69. Miller/Howard Investments has prepared all performance results. AIMR was not involved in the preparation or reporting of these results. A complete list of all the firm's composites is available. Portfolios are typically fully invested, and hold minimal cash although cash holdings may fluctuate somewhat on a residual or transitional basis. Inception of the composite was 3/31/97. No representation is made that future returns will approximate past results, and none should be implied.

Benchmarks: The benchmark data from which this report is prepared has been provided by sources generally considered reliable. Except for benchmark returns based on published mutual fund net asset values, and unless otherwise stated, the index performance figures contained in this report do not reflect the deduction of investment advisory fees. Mutual fund data published by Lipper are net results after deductions of all annual fees and expenses by the advisor. Benchmark returns are presented on a total return basis unless otherwise stated.

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