

## 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.

#### DISTRIBUTION / EMERGING UTILITIES

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

#### 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."*

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In our first and second quarter reports we proposed hints of a return to a more balanced environment, a more—dare we use the word—rational market, that vision of yesteryear in which stocks are bought and sold based on their demonstrated prospects and asset values. At the end of last quarter we suggested that the “picture remains mixed, yet stocks with good fundamentals are consistently finding buyers now...” While one could hardly propose that the third quarter manifested an investor return to sanity en masse, there were indeed continued signs of progress or healing. Unless of course you’re involved with the limelight NASDAQ issues, which continue to exhibit the burps and belches and squeals and daring-do of the nascent industries that characterize this area.

How can we be talking about “healing” and a “more rational market” in the face of negative year-to-date performance from all of the major averages? Quite simply, market breadth (the number of advancing versus the number of declining stocks) has improved quite noticeably, with a consistently increasing trend through most of the quarter and since the April/May lows. What is the meaning of this?

With the renewal of positive breadth indicators there have been numerous commentators emerging from behind their secret doors to argue that breadth isn’t a good indicator of future market direction. But these observers are defining a market by movement in the major indices, rather than by investor returns. And investors, unless they are just investing in the indices, survey a broad panorama of stocks before deciding on their choices based on, hopefully, rational analysis. Breadth is not an indicator, really, it is a *condition* which tells you something about your opportunities as a rational investor. If conditions are such that five out of every ten stocks are rising, well, you’ve at least got half a chance that your choice will be among the good ones. But if eighty percent of stocks are stagnant or falling—no matter what the indices are doing—the raw odds of your choice’s stock price following its fundamentals are greatly reduced.

Indeed, now that the market has broadened out somewhat, eureka, active managers are once again outperforming the indices. It is rather more than a coincidence, we think, and active management was as likely to outperform indexing as night follows day—once investors and their windy shepherds had decided to embrace indexing as the cure-all for their frustration over seeing slightly greener grass in the next yard for a few years.

*“But if you view the actual market, as opposed to the indices, opportunities abound and results are forthcoming.”*

But the character of those few years—from spring of 1998 to spring of 2000 should not be forgotten. It was a unique and anomalous period in which literally a dozen stocks made investors feel like ignorant children as the indices gained steadily—without a concomitant rise in most investors asset values. Indeed, many investors were perplexed to see their returns fall to zero and less during years when the S&P 500 rose over 20%. The few “power” stocks had an incredible ability to move the indices higher while the remaining companies could not find a buyer no matter how much business success they offered. This disjunction reached a fever pitch during the winter of 2000 as many NASDAQ stocks doubled and tripled and more in a few months. Then, at the end of the first quarter the bubble burst, and that concert was over.

We and others pointed out all during this period, probably sounding as though we protested too loudly, that, in fact, while the S&P 500 was rising the majority of stocks were in a severe bear market. There’s no need to trot out the statistics: stocks in general came down toward the end of the second quarter of 1998, and with rare exceptions, they did not come back. That is why the equal-weighted Value Line Index of 1700 major stocks has done so poorly for several years. There has been a bear market afoot, though it never made the cover of *Time*.

At long last, investors should have some cause for rejoicing. There has been evident buying of sufficient duration to imply, in our view, that a wide swathe of stocks have reached rock bottom and are finding willing buyers, New Economy enticements notwithstanding. The hidden bear market that affected the majority of stocks, appears over.

At a minimum, some semblance of rationality is returning to stock pricing.

Because of the drawn-out quality of the previous rejection of classic fundamentals by investors, it will take many quarters before prices return to anything like “fair,” or, if not that, at least to historic norms. Why should investors consider rejoicing? If we look away from the tech-heavy indices, stocks are not expensive, and their support in the market is becoming more apparent. We don’t think it is too radical to suggest that we are beyond the bottom of the previous broad-market bearish period. That being the case, who would not rejoice in being able to buy stocks after the end of an extended bear market?

Our portfolios are a case in point. Each of our strategies provided double-digit gains (or nearly so) this quarter and year-to-date, despite negative performance of the popular indices. If you look at the indices in isolation, the market looks and feels ugly. But if you view the actual market, as opposed to the indices, opportunities abound and results are forthcoming. One might ask: just what are the indices indicative of? But that is surely a topic for another time. □

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#### SELECTED INDICES

	3 <sup>rd</sup> Qtr’00	12Mo
<b>S&amp;P 500</b>	-0.97	13.28
<b>Equity Inc</b>	5.70	8.53
<b>Util Fund</b>	7.40	24.29
<b>DJUA</b>	30.90	38.91
<b>LB Treas</b>	2.78	9.79
<b>LBGC</b>	2.87	6.74
<b>S&amp;P 400</b>	12.15	43.21
<b>Val Line</b>	2.94	0.53
<b>Rus 2000</b>	1.10	23.34
<b>Rus 2000 Val</b>	7.34	15.36

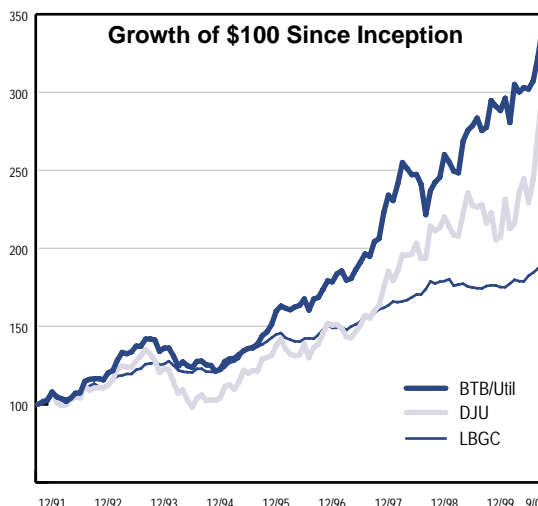
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S&P 500 = Standard & Poor’s Index  
 Equity Inc = Ave Equity Income Fund (Lipper)  
 Util Fund = Ave Utility Fund (Morning Star)  
 DJUA = Dow Jones Utilities Ave  
 LB TREAS = Lehman Long Treasury  
 LBGC = Lehman Bros. Gov/Credit Bonds  
 S&P 400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

You may recall that in our 4<sup>th</sup> quarter 1999 report, published in early January, we extended our necks precipitously far, suggesting that valuations had become absurdly low in the face of improving fundamentals, and that it was “the best time since summer of 1994 to buy utilities.” Any investor or manager ought not to make extreme statements (since no one has a crystal ball), and we risked misperception as engaging in some kind of promotional ballyhoo. After all, the markets were in the midst of renewed Fed tightening, energy prices had begun to rise, utilities as measured by the indices were in the investor doghouse, and funds were flowing like a raging river into nubile new economy upstarts with unfamiliar names and inexplicable businesses. Why would any sane investment manager unnecessarily go out on such a limb in such a swirling mix of circumstances?

There really is no reasonable explanation for this behavior, so we’ll have to chalk it up to yet another instance of inadequate character development, and swear not to engage in overt prediction for at least another few years. But, as luck would have it, this *has* been one of the best periods in history for utility investors (with the exception of those totally focused on Telecommunications, which have been a disaster so far). Not since the bear market recovery snap-back of 1975 has the Dow Jones Utilities, for example, had such strong returns.

A number of factors entered the equation. First, as we had noted in the beginning of the year, utilities generally were undervalued relative to their historic measures, relative to the broader market (we pointed out last quarter that the relative PE was 40% of the S&P 500, compared to a more “normal” relationship of



70-80%), and relative to their prospects. Few investors had recognized that a broad sweep of companies in the sector had rationalized and revitalized their businesses, and owing to restructuring as well as the profit opportunities presented by deregulation, these companies were becoming double-digit growth enterprises—while still selling at P/E multiples in the low teens. Further, deregulation had set into motion a wave of consolidation and convergence resulting in a tremendous level of M&A activity in 1999. The numerous mergers and takeovers resulted in a clearly established “private market value” for various types of utility companies. But the constant flow of deals did not inspire takeover speculation: remarkably, the majority of companies were selling far below their private market values as established by a record number of deals.

Too, when the new economy stocks collapsed, investors began to seek stocks with “black ink” on their bottom lines, and few sectors sport as many consistently profitable companies as utilities. Utilities became a kind of hiding place in which non-utility investors sought refuge during the Great Technology

*“Too, when the new economy stocks collapsed, investors began to seek stocks with “black ink” on their bottom lines, and few sectors sport as many consistently profitable companies as utilities.”*

**Quarter Composite Net of Fees\***

BTB/Util (Preliminary)	13.06%
DJUA (total return)*	30.90%
LBGC*	2.87%
Ave Util Fund*	7.40%

**YTD Composite Net of Fees\***

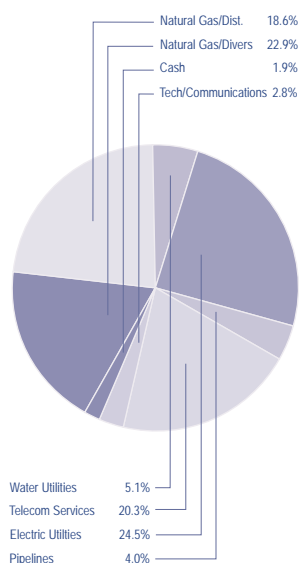
BTB/Util (Preliminary)	18.52%
DJUA (total return)*	44.74%
LBGC*	7.17%
Ave Util Fund*	10.14%

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

BTB/Util (Preliminary)	23.09%
DJUA (total return)*	38.91%
LBGC*	6.74%
Ave Util Fund*	24.29%

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

Troubles. Indeed, on up days for technology, utilities were typically down, and on down days for technology, utilities were typically up. Utilities gathered momentum and some have even become the playthings of momentum investors. Wall Street has jumped on the bandwagon, too, after ignoring the sector for years. This phenomenon we find hard to love, but more on that later on...



Our fine returns of the past quarter and year have brought us to what we like to think of as Tortoise Heaven. We have been pointing out for a few years that our returns have outpaced those of most traditional categories. In fact, over the past three years we have outperformed small, medium, and large-cap value, small and medium cap growth, every kind of fixed income, the unweighted Value Line Average, the average equity mutual fund, international, and, ta-dum, for both the trailing twelve months and the trailing three years, we have outperformed the S&P 500.

## PORTFOLIO HIGHLIGHTS

The portfolio was led by surprising large gains in a number of our traditional utility holdings, stocks that have been in the portfolio for years, stocks which we have felt were under-appreciated (though from the recent evidence we may have under-appreciated how under-appreciated they were). Right at the top of the list with a gain of nearly 40% was TECO Energy (formerly Tampa Electric), a company back on the earnings track which had made it one of the best performing utilities for many years until a slowdown in the recent times. Refreshed management, renewed focus, a revised regulatory structure all helped, and the fact that both of the other investor-owned utilities in Florida have been involved in mergers (FPL an acquiror, Florida Progress and acquiree) could not have hurt.

Also starring in terms of performance was Questar, one of our favorites in recent quarters. This Rocky Mountain gas distributor and pipeline owner has been improving its utility operations, to be sure, but we doubt that utility improvement alone could be responsible for its 30% gain for the quarter and 78% gain for the year to date. As our investors are aware, we attempt to hold solid utility stocks that have a “growth kicker,” and Questar has one of the best in today’s environment—ample supplies of natural gas. The company has doubled both its reserves and its production the last five years, and sits on an exploratory field which may be of monumental proportions, a field which could turn the company into a major name in domestic gas production. (You may wish to read further detail in an excellent article by Harlan Byrne in Barron’s September 11 issue. It is posted on our website at [mhinvest.com](http://mhinvest.com)). If the quantity of gas is proven as anticipated—and we should know quite soon—this stock is still very cheap. If not, it remains a reasonably priced utility with ample moderate growth in its future. The weight has obviously risen in our portfolio, but we aren’t inspired to trim it back as might be our normal response to an extraordinary rally.

Our pipelines Enron and El Paso Energy, as well as Kinder Morgan and KN Energy turned in good performances, as one might expect in a time of high gas demand, but they were joined by gas distributors such as NiSource, AGL Resources, NICOR, MCN (which has a pending deal to be acquired by DTE but still remains a bargain relative to the merger price), and, in particular, another longtime favorite, Keyspan. Keyspan (formerly Brooklyn Union) is up 65% this year, and has finally been re-rated to the kinds of valuations we felt for some time that it deserved. Indeed, in the beginning of the year KSE was, in our view, a prime takeover candidate considering

### UTILITIES PORTFOLIO CHARACTERISTICS

Beta*	0.48
Dividend Payout	64.09%
Sharpe Ratio	1.16
Projected Dividend Growth	4.78%
Treynor Ratio*	28.35
Current Yield	3.29%
Annualized STD	11.69
Market Cap (MDN)	\$4.6 Bil
Price/Book	2.54
Quality	B+
P/E Ratio (MDN)	15.95

\*Relative to DJIA, 9/30/95-9/30/00

its low valuation and strategic interest to any of a number of Northeast consolidators, and still remains a candidate, though not quite as prime. The company got off to a slow start after its acquisition of Long Island Lighting's gas business and some electrical generating assets, but it's in a kind of sweet spot now. They are successfully generating electricity in a high-cost region, they are growing their gas business as they expand in Long Island, and like Questar, the company has substantial interests in oil and gas production through its ownership of a 64% stake in Houston Exploration—a stake which management mercifully decided not to sell several years ago.

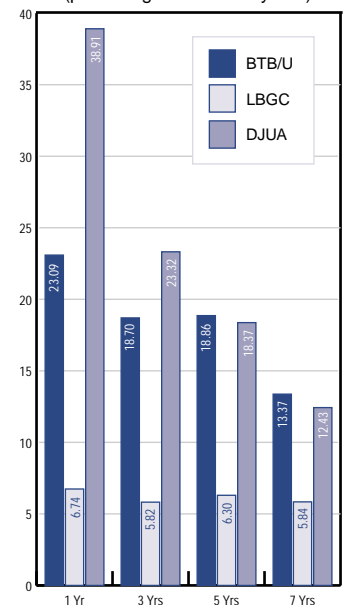
But a testament to the performance power of our suddenly high-kicking tortoises was their ability to maintain good overall performance for the portfolio in the face of perfectly dismal performance from the Telecom Sector. The world turns, and where last year our performance was floated higher by telecoms and takeovers, this year there have been fewer takeovers and the telecoms have gone from best to worst. In some cases the performance has been so extreme as to trigger a buy signal from what we have sometimes called our tempero-mandibular indicator (when your jaw involuntarily drops as a result of incomprehensible price declines in a company you know well, it's time to buy!). For the quarter, ALLTEL was down 16%, despite across-the-board improvement in its business. Worldcom was down an astounding 37%, reaching levels at which its PE ratio and growth rate are approximately equal (an event never before recorded for this company). BellSouth and Qwest were pillars of strength, each one declining less than 10% during the period. Our newer stock Telephone & Data Systems managed a gain, as did SBC Communications, but these were distinct exceptions in the group, whether held in our portfolio or not. To offer some sense of the damage in this area: the Dow

Jones Telecom Index was down about 25% year-to-date at quarter's end, and the Wireless Index was down about 30%. CLECS and alternative companies, such as pure fiber providers and fixed wireless, were even worse. AT&T, the mother of all telephones, so to speak, (which we don't own right now) offers a dismal loss of 43% for year-to-date to the millions of widows and orphans who surely still hold it.

However, there are opportunities here. Late last fall we sold Sprint, when FCC commissioners reacted to the proposed Worldcom/Sprint merger with wagging fingers and firm threats not to approve the deal. Selling in the low 60's, we felt a sharp decrease in self-esteem as the stock continued up to 70, just below what Worldcom had agreed to pay. In June, however, we would have had the last laugh if we were the type to laugh at other's misfortunes, since in fact the FCC did turn down this merger (it was subsequently joined by the European Union Commission. Both stocks fell apart, Worldcom for its lack of a wireless presence (the prize for Worldcom was Sprint's PCS business), and Sprint for lack of a suitable suitor, with Deutsche Telecom otherwise engaged and the authorities making transactions a difficult fantasy for other potential buyers, buyers whose stock "currency" had recently depreciated as the air escaped from telecom land. Too, arbitrageurs got destroyed holding Sprint, prompting even greater and more irrational selling as they bailed out. Now Sprint sells for 40% of the price that Worldcom, presumably with greater expertise in telecom values than we, was willing to pay for it a few months ago. Too, the market capitalization of Sprint's PCS business alone is greater than the capitalization of the parent company, meaning that an investment in the parent gets you PCS for free. The yield is almost equal to our overall portfolio yield (unusual in a telephone stock today). This kind of configuration is a "must buy" for us, and we've added it to the portfolio.

*"But a testament to the performance power of our suddenly high-kicking tortoises was their ability to maintain good overall performance for the portfolio in the face of perfectly dismal performance from the Telecom Sector."*

Seven Year Average Annualized  
9/30/93 - 9/30/00  
(percentage of return in years)



## LOOKING FORWARD

*“Utilities have always been one of the best performing groups over long periods, it’s just that very few investors are aware of it.”*

The fact that every Tom and Louise on Wall Street is suddenly head over heels in love with utilities kind of gives us the creeps. While our portfolio has become in recent years increasingly detached from the movements of the Dow Jones Utilities Average and the large-cap electrics that are so often “meant” when people think of utilities in general, it’s always easiest to make progress when the overall utilities environment is positive. At this point we have some concerns about the large-caps. In the roiling global turmoil of 1998 these same stocks were employed as a hiding or parking place by investors not really committed to the sector, becoming the “long treasuries” of the equity markets. It was just about this time that the mania for large-cap utilities waned, and the stocks began a long cold descent which lasted through December of 1999, resulting in a 9.3% price decline during 1999, one of the worst years in recent times for the DJU.

Speaking of Louise, Louise Yamada of Salomon Smith Barney issued a report in August citing the “13-year breakout” of utilities (she was referring to price charts, of course) and suggesting that utilities “may be emerging as the new ‘basic materials’ for the new technological era... This particular advance in Utilities may now be initiating a sustainable structural uptrend that could last for years.” Sounds great to us, but, unfortunately, this piece was penned by a technician. We have quite a bit of technical background ourselves, and great respect for the value of technical work as a tool, but, quite frankly, we’d much rather be buying utilities on “breakdowns” rather than “breakouts.” These are solid companies and not stocks with blue-sky possibilities. It is an area where re-rating upward has definitely been too long in coming, but the recognition of a newly robust fundamental underpinning for the large electrics should not necessarily lead to the conclusion that these items are a slam-dunk for the next ten years. New generation will be built like mad over the next 2-3 years, resolving the current power shortages.

*“Just now the large-cap electrics (which we don’t own) are due for a breather, and will definitely get one if more aggressive kinds of issues find buyers once again—thus removing the ‘hiding place’ character of some recent utility buying.”*

Utilities may or may not be intimately involved in the power conditioning necessities of the New Economy, and may or may not participate greatly in new distributed power initiatives such as fuel cells and microturbines (both whose market potential is completely unknown at this point).

Plus, there is the R word, which stands for regulators, a factor with which other kinds of companies do not have to cope. Further, why point to breakouts? Utilities have always been one of the best performing groups over long periods, it’s just that very few investors are aware of it. Speaking of awareness, we don’t want to pick on Ms. Yamada (whom we consider one of the brighter lights on Wall Street) and her staff, but it’s difficult to take her case seriously when among the “strong buy” breakouts cited are two stocks (Coastal and Florida Progress) whose good-looking charts are the direct result of having previously received takeover offers.

Just now the large-cap electrics (which we don’t own) are due for a breather, and will definitely get one if more aggressive kinds of issues find buyers once again—thus removing the “hiding place” character of some recent utility buying. Short-term, a fairly sharp retracement is possible in this area. In the gas industry, where we are heavily weighted, many stocks have moved closer to fair value. But we believe the underlying gas market—both in terms of volume and price—will support these stocks for many years to come. While in some sense we’re uncomfortable when our stocks appreciate, the risks in this area still appear modest.

Telecom is another story. There are many issues in this area selling at valuations which were more typical of electric utilities in the past. It is quite common now to find major telecom stocks whose growth rates are greater than their price/earnings ratios, and that is a rare condition indeed for companies of such importance and earnings reliability. As we write, bottom-fishers are nibbling quite obviously. It’s not certain that a full recovery will occur as early as this quarter, but it should be no surprise if it does. □

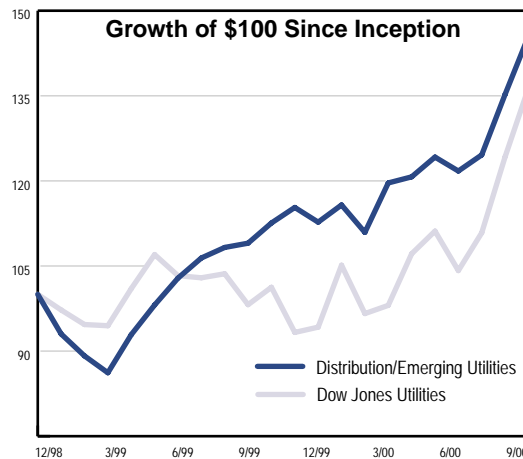
Last quarter we expressed some grumpiness over an eleventh-hour swoon in utilities which dragged our portfolio down from a solid gain to a small one for the period, but offered appeasance at the same time, noting that the portfolio supplies that most precious of investment attributes: it is easy to hold. This quarter our stocks went rather far beyond “easy to hold.”

Remarkably, virtually all of the gains stemmed from a re-rating of the values of our companies—abetted by a strong wind in favor of utilities generally, of course—since takeover activity was mild during the quarter. We’d suggested earlier that the portfolio had strong potential in each security with or without a transaction, but the magnitude of gain without noticeable help from deals was frankly surprising.

While the acquisition candidates may have become somewhat more expensive (though they are still cheap by any rational measure), their acquirers have suddenly become much richer. The “currency” used in these transactions is typically about 50% cash and 50% the acquiring company’s stock. Now that acquisition stock is much higher, so it is easier for companies to do deals for cheaper companies that will be immediately accretive to earnings and asset values per share. Basically, the entire playing field has been ratcheted up a notch, but the relative valuation attractions have not changed.

## PORTFOLIO HIGHLIGHTS

New additions from the second quarter helped us substantially. Western Resources, which had been sold down to absurd levels, rebounded nearly 40%. Niagara Mohawk, which we purchased as a result of its exit from the generation business (and final resolution of terrible treatment from regulators regarding



purchased power costs), received an offer from National Grid, giving us a gain in the teens, with more to come as the deal works its way to completion. We also added GPU, since there’s a 20+% total return in store from their deal with FirstEnergy coming due within the next year. Elsewhere, we did well with Keyspan, TECO, Utilicorp, RGS, NUI, Energen, and, indeed, most of our list.

## LOOKING FORWARD

Certainly the rate of change for this portfolio is due to slow down this quarter, but there remain many attractive stocks in our group, and a number which we will shortly be adding. Too, the decimation of the telecom sector has added an additional team of candidates offering what has become the benchmark criterion for the strategy: one year potential of 50% appreciation or more, minimum risk based on asset values and underlying growth. As holdings depart the portfolio through stock price increases, we will be thinning or eliminating appreciated issues in favor of the stocks in our universe with the best risk/reward profiles. While the past quarter’s results appear to have redlined our tachometer, performance even half as good in the coming quarter would still be extremely attractive, and we think it is achievable. □

This portfolio will soon be closing to new investors. We’re in the process of starting a hedge fund, **The Utility Convergence Fund**, that will take advantage of the consolidation and convergence in the utility industry.

### FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	3.95%
<b>Proj Div Gro</b>	3.21%
<b>Payout Ratio</b>	75.00%
<b>Market Cap (MDN)</b>	\$1.8 Bil
<b>Price/Book</b>	1.87
<b>P/E Ratio (MDN)</b>	14.66
<b>Quality</b>	B++
<b>Beta*</b>	0.34

\*Relative to Dow Jones Utilities Index (9/30/99-9/30/00)

### Quarter Composite Net of Fees\*

Distribution (Prelim)	19.54%
DJUA (total return)*	30.90%

### YTD Composite Net of Fees\*

Distribution (Prelim)	29.10%
DJUA (total return)*	44.74%

### 12 Month Composite Net of Fees\*

Distribution (Prelim)	33.50%
DJUA (total return)*	38.91%

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

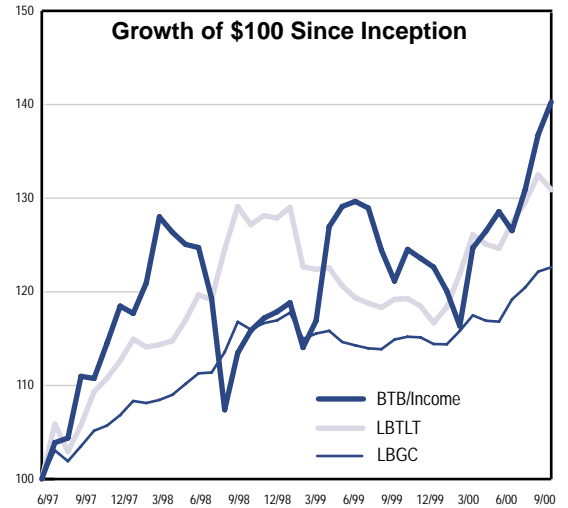
*“The ‘old economy’ looks better and better compared to the volatility of the new”*

Last quarter we suggested that with a bit more market breadth our portfolio could move from just outperforming bonds (which is our minimum goal, of course) to registering returns more typical of the long-term equity markets. After all, the fundamentals of our companies have for the most part been improving for the past couple of years, but equity investors have all but ignored them. This quarter we did get an improvement in breadth, and, as a consequence, we experienced double-digit returns at a time when most investors were struggling to stay above water.

### PORTFOLIO HIGHLIGHTS

Gas related issues once again helped our portfolio. Questar, which we discuss in more detail in our utilities report, gained 43.6%, aided by a Barron’s article pointing out its attractions. Keyspan, another gas utility with a “growth kicker” in energy exploration and production, also helped. Equitable Resources (a utility not found in our utility portfolio) was a strong performer (up 31.4%) as was pipeline and producer KN Energy (PEPS Securities, up 16.3%), a convertible now connected to Kinder Morgan, Inc. And, as is so consistently the case, our Kinder Morgan Energy Partners MLP supported the cause with a 18.6% gain.

But we weren’t just gas. Market participants have begun to perceive the Federal Reserve as finished with its tightening work. Whether or not that’s the case—and we tend to think it is, though with some reservations—this new perception added to a number of takeover transactions in both the banking and the brokerage industries giving a boost to the



financial sector and to our related shares. Washington Mutual, which seemed to be going for giveaway prices when we first added the stock to our portfolio in January at \$24.60, seems on it’s way to a double, and gained 38% for the quarter. Slightly lame Union Planters found support and showed interesting signs of life, rising 18.3%. The stock recently appeared on a significant “most likely to be taken over” list. Lincoln National preferreds also gained; this fairly dowdy item provided a 17.2% gain for the quarter.

Electric generation was a hot hot hot area of the market this summer, and we were able to participate through our position in AES convertible preferreds. TECO Energy, a vertically integrated electric with generating capacity was lofted by the general mania for electrics as well.

Fortunately, these good performers more than made up for a few disappointments. PSINet preferreds got hammered as the company reported worse than expected results, and was undermined by investor fears of a capital draught in the entire competitive telecom

#### Quarter Composite Net of Fees\*

BTB/Income (Preliminary)	10.86%
LBGC	2.87%
LB Long Treasury Index	2.78%

#### YTD Composite Net of Fees\*

BTB/Income (Preliminary)	14.37%
LBGC	7.17%
LB Long Treasury Index	12.15%

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

BTB/Income (Preliminary)	15.77%
LBGC	6.74%
LB Long Treasury Index	9.78%

\*See Performance Disclosure on page 12.

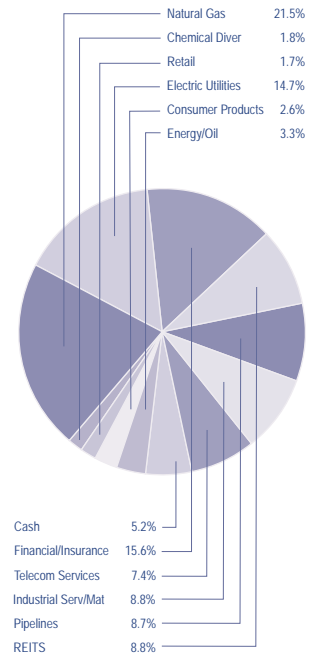
category. We sold, with a view toward re-evaluating the security later. AmSouth reported a serious downside surprise which revealed an inability to cope with even moderate short-term rate increases as well as an apparent lack of candor with Wall Street analysts. But the damage has been done, we think, and rebuilding on all counts starts from here. Given the company’s strong geographic franchise, it now appears a ripe acquisition candidate. And perhaps we might have listened with less of a contrarian’s ear when Imperial Chemical was voted “worst company in Europe.” Now that their dividend policy has become, in the words of one analyst, “nebulous,” we’re on the lookout for a good selling point.

We sold shares in stocks in which the closing of a transaction is imminent, such as Eastern Associates and E’town Water, and added both GPU and Genuine Parts. GPU has an announced deal with First Energy in which shareholders will receive \$36.50 (within one year, we believe), yet we were able to buy the stock below \$32. Coupled with a 7% yield, we’re content to limit the upside for a “guaranteed” return of 20+%. Too, it’s not impossible that a more generous suitor will emerge in the interim, since the deal was a fairly modest one. We could hardly resist Genuine Parts at a yield of more than 5%. This is the dominant aftermarket auto parts company (NAPA) with a stellar long-term growth record. It’s truly a fallen angel, but we don’t believe it’s wings are clipped, save by myopic investors who’ve overlooked real things in the quest for youthful promise. The stock would not be expensive and could easily double over time. There are not many 5+% yielding stocks that

have raised their dividends every year for more than 40 years, sell at a PE of 9 on this years earnings, and sport among the best financials in all of coporate America (working capital, for example, is equal to 2/3 of the share price), and have historically sold at a P/E premium to the market averages.

### LOOKING FORWARD

Conditions for this portfolio remain promising, though several of our stocks may be subject to profit-taking in the near term. We continue to find banks and industrial stocks selling at yields which are more attractive than bonds but which have excellent long-term growth prospects. A number of stocks are under pressure due to concerns about the Euro or energy, and these will become new buying opportunities when the complexion of those issues changes. The “old economy” looks better and better compared to the volatility of the new; we think our area will receive a significant vote this November and beyond. The current yield on this portfolio is 5.9% and average projected growth of yield is 5.25%. □



#### FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	5.90%
<b>Proj Div Gro</b>	5.25%
<b>Payout Ratio</b>	65.09%
<b>Market Cap (MDN)</b>	\$3.5 Bil
<b>Price/Book</b>	2.77
<b>Beta*</b>	0.34
<b>P/E Ratio** (MDN)</b>	11.12
<b>Quality</b>	B+

\*Relative to LBGC, 9/30/97-9/30/00  
 \*\*Reit's use P/FFO ratio rather than P/E Ratio

*"We often say 'easy to hold' is the key feature of a successful long-term investment."*

In the third quarter the broad market continued its shaky but steady move toward normalcy and our SBI portfolios shined, handsomely beating most equity indices. For the third quarter our composite net of fees was up 6.87% versus 2.94% for the Value Line Price Index. Year-to-date we were up 22.5% compared to the Value Line at -2.59%. What's most intriguing to us is that our returns were achieved with a weight in the technology sector roughly equal to the S&P 500 (nearly 30%). We find ourselves again reminded that individual stock selection and proper diversification is essential in creating a portfolio flexible enough to participate in market rallies, but cushioned against the kinds of volatility we've seen in recent months, particularly in the tech area. Our tech stocks have had a strong value component, and have not broken during periods of panic tech selling. And during just those times the financial and industrial stocks have come to life, with many of our issues leading the charge. This balance in the portfolio has enabled us to generate excess returns through stock-picking, having neutralized the sharpest of the sector movements with solid representation.

**Quarter Composite Net of Fees\***

SBI (Preliminary)	6.87%
Value Line Index	2.94%

**YTD Composite Net of Fees\***

SBI (Preliminary)	21.50%
Value Line Index	-2.59%

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

SBI (Preliminary)	31.28%
Value Line Index	0.53%

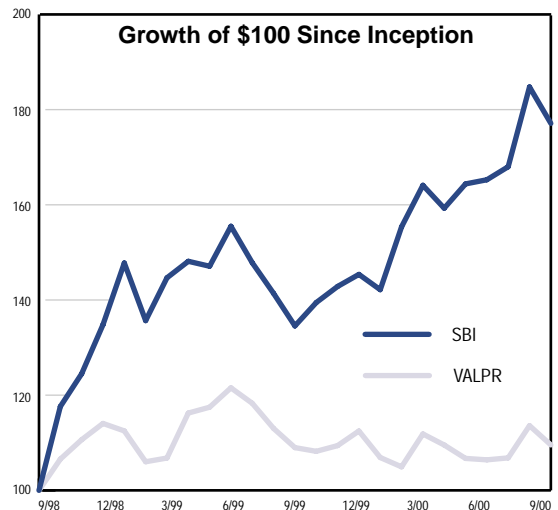
*\*See Performance Disclosure on page 12*

**PORTFOLIO HIGHLIGHTS**

We were quite content with most stocks acquired earlier this year and made few changes in the portfolio. As we suggested last time, our financials made a big contribution to returns. Among the leaders were Washington Mutual (up 38% for the quarter), Lincoln National (up 33%), American General Corp (up 29%), followed by Bank of New York and Citigroup, both better than 20%.

Pharmaceuticals continued to do very well after analysts fell head over heels in love with the generics group, as a pocket of unexploited growth with good secular prospects. We used this opportunity to take profits in Alza—perhaps

a little prematurely if you can call a 12-month double a premature sale. We also closed our position in Watson Pharmaceuticals after the company announced that it will miss estimates through next year because of slow sales at one of its recent acquisitions. Although we still believe it's a sound company with a solid pipeline and long term potential, in this market, with its daily hangings and floggings of stocks that commit misdemeanors, it's better to be safe than sorry. In this case we see with 20/20 hindsight that we would have been better off holding on,



for the short-term at least, but we made the choice to look elsewhere rather than await what may possibly be even more disappointing news from the company. We'll surely look again later on, however.

Among the top performers were a couple of tech stars, EMC Corp, Wind River Systems and General Motors H (Hughes Electronics), going against the flow of the weak tech markets with an average gain in the upper 20s for the quarter. As stockpickers, we're quite pleased when our securities are able to sail on against a strong headwind.

Tyco International, which we stood by despite what we perceived as a bogus SEC

accounting investigation, was set free early in the quarter as the investigation was dropped and the company vindicated. This has put the stock back on the institutional and brokerage buy-lists, and the company, which may be a tech name or may be a conglomerate or may be simply a value stock with a track record of growth, looks like a long-term winner at this point, still at an attractive price point.

In telecom equipment we replaced Lucent with Motorola, avoiding a 40 percent slide in Lucent's market value since July caused primarily by numerous warnings and heavy exposure to the suddenly out of favor long distance voice business. Motorola has been slow getting off its feet, but we remain confident in its ability to be a leader in the broadband communications sector, especially with the rollout of the third generation wireless networks and the implementation of Bluetooth functionality which allows devices to interact using short-range wireless signals. In addition, we believe that cable voice could become a tremendous growth opportunity for MOT. And although the competition will be fierce, strong relationships with cable operators and carriers should allow it to become a bigger player in the telecom market going forward. In any event, Lucent is on the downswing and expensive, while Motorola is moving up in its business and cheap, so we swapped.

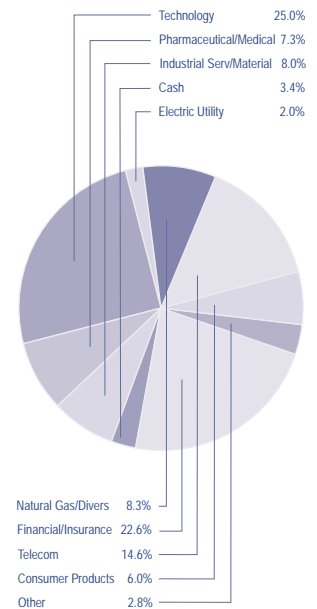
We've been too light in energy, so during a pause in the parade we added Vintage Petroleum to the list of our holdings. The stock has been on our watch list for a while as one of the successful producers with an excellent acquisition record, an improved balance sheet and historical dividend growth of over 20%. We believe that the stock is undervalued trading at a 20% discount to its historic EBITDA levels, and has great potential both in the exploratory business and future acquisitions.

Also in August, we added Genuine Parts. It's a classic "SBI" stock with a 40-year string of earnings and dividend growth (tough to top that

record!). This national distributor of auto spare parts and accessories is being valued at close to half its normal historical averages (P/E of around 9x, for example), though sales, cash flow, earnings, and a 5% dividend yield are all much higher than in past years when the stock sold at a P/E in the high teens or even in the twenties. In addition to a top-notch business, low debt and decent projected growth, this company has a mountain of cash, about sixty cents for every dollar of share price today. We'd like to buy the whole thing, but we just don't have enough money.

## LOOKING FORWARD

Looking forward into the next quarter and year, we'll continue our focus on value, special situations, market dominance and sound fundamentals in our stock selection. Though the markets have been turbulent and the major indices are all in negative territory as we write, it's tough to be anything other than confidently optimistic when we survey the long list of potential buying candidates that spreads out before us, candidates in nearly every sector. We have an absolute value orientation, and when there are as many absolutely cheap issues as we see today, it is easy to ignore the noise that may press for attention from day to day. There was a period when even strong absolute value was ignored, but that period was not long-lived, and now that we've seen investors return to their senses even after the siren song of the new economy distracted them mightily, we can hold our shares with ease. We often say "easy to hold" is the key feature of a successful long-term investment. Though we're not against making changes in the portfolio when appropriate, for now, in any event, "easy to hold," is our theme song. □



## FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	1.16%
<b>Proj Div Gro</b>	11.93%
<b>Payout Ratio</b>	39.45%
<b>Market Cap (MDN)</b>	\$20 Bil
<b>Price/Book</b>	4.11
<b>P/E Ratio(MDN)</b>	21.98
<b>Quality</b>	B++
<b>Beta*</b>	1.01
<b>STD</b>	20.57
<b>Sharpe Ratio</b>	1.35
<b>Treynor Ratio*</b>	27.52

\*Relative to Value Line Index (9/30/98-9/30/00)

**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 9/30/00 was 170, which represents 40% of total assets managed in this strategy with a measure of dispersion of 0.48. Inception of the composite was September of 1991. (Note: The composite represents only 40% of assets managed in this strategy because two large clients, a mutual fund and a pooled fund, are not included due to excessive and non-regular cash flows.)

**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 9/30/00 was 18, which represents 78% of total assets managed in this strategy with a measure of dispersion of 0.75. Inception of the composite was May of 1997.

**SBI:** 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 9/30/00 was 7, which represents 100% of total assets managed in this strategy with a measure of dispersion of 1.05. Inception of the SBI composite was September of 1998.

**Distribution:** 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 9/30/00 was 22, which represents 99% of total assets managed in this strategy with a measure of dispersion of 0.24. Inception of the Distribution composite was December of 1998.

**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 and Morningstar are net results after deductions of all annual fees and expenses by the advisor. Benchmark returns are presented on a total return basis