

MARKET OVERVIEW

THE STRATEGIES

BETTER THAN BONDS / INCOME

A fixed income alternative/equity income approach utilizing reliable dividend growth companies from across the broad market. Stocks are conservative, high quality, high yield, and are projected to have a rising stream of income.

BETTER THAN BONDS / UTILITIES

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

DISTRIBUTION / EMERGING UTILITIES

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

THE SBI PORTFOLIO

Based on the strategy detailed in Lowell Miller's book, *"The Single Best Investment,"* the SBI Portfolio combines value analysis with stable, moderate growth prospects from all sectors. The portfolio emphasizes companies with reliable dividend growth as well as strong fundamental characteristics.

ALPHA-BASED STRATEGY

An aggressive strategy focusing on small and micro-cap stocks using both value and momentum analysis. Seeks high returns and protects against high volatility with strategic use of cash.

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We need to begin our discussion with an expression of sorrow for the men and women who died in New York City, Pennsylvania, and Washington; their families, friends, and colleagues. There is a gaping hole in downtown New York, and an even larger one in the lives of all those affected. We're helpless to do anything about what happened, but we can try to be a little more loving in our everyday lives, a little more attentive to what is precious and fleeting in ourselves and those we know. And a little more open to those we don't know—we can't imagine how much their lives might one day mean to us.

From an investor standpoint, the attacks have produced the same kinds of effects that they have in the larger world: confusion, hesitation, rogue fantasies, and lack of enthusiasm for long-term plans. And yet deep within, investors know, as do ordinary citizens in whatever pursuit, that our country and the Western world are strong, our economy is fundamentally strong if a bit bruised in the short term, and, if history is any guide, we will emerge stronger and more prosperous than ever. And it is inconceivable that a global alliance of virtually every country in the world, each and all intensely focused on solving the problem of terrorism, cannot find and vanquish 5,000-10,000 mentally unstable terrorists.

The good news, and the news that will ultimately outlast this phase of history with positive consequences, is the Global Alliance itself. Geez, even the French are on board! Never in our lifetimes have so many countries come together in a spirit of cooperation to achieve a concrete goal. We have to believe that agreement on even one thing, and contact, and working together, must help lay the groundwork toward future cooperation, toward free trade, and toward peace. It's sad that it took a tragedy to bring the countries of the world together, and surely some will revert to bickering and posturing as time goes by, but at least the countries have come together, at least one time. That step can never be taken back.

We sent clients and friends a letter at the end of September. Our thoughts haven't really changed since then, and we have no better way to express it, so we here reprint a few paragraphs:

continued on next page

“Staying the course when times are troubled has also been the hallmark of successful investors.”

“What should stocks be worth in today’s world? This is really the big question today, and we fear the answer is not yet apparent. How much will life change in the future? How much will it cost corporations and governments? Will the costs produce inflation? Will the waves of liquidity being injected into the economy be enough to establish a bottom and a base from which companies can begin to rebuild their profitability? Will it be too much, and result in asset price inflation (a stick that offers both pleasure and pain)? How quickly can we catch at least some of the leading terrorist culprits, permitting consumers some measure of secure feelings?”

These are open questions, and certainly stock prices need to be re-rated up and down to reflect the answers that evolve. But hiding in fixed income right now is not the answer for investors. The low-rates from short-term instruments are almost torturous, and longer bonds are poised for a bad run as stability and economic growth return (added to the sudden new level of government spending at all levels). Investors throughout history have always done best through buying during uncertainty and panic, buying, as they say “low.” Conversely, the proven path to underperformance and losses is to sell declines. Indeed, recent studies have shown that six months after an “external” crisis (war, assassination, earthquake, etc) the markets have been higher, on average and in nearly every instance. It may be emotionally difficult now, but the probabilities say buying is a better idea than selling.

Staying the course when times are troubled has also been the hallmark of successful investors. We are not changing our approach to investing, which is primarily company-specific, though we are keenly interested in the state of the world, the country, and the

economy. We believe that five years from now the current moment will not be seen as some kind of watershed after which everything had changed radically, but more as a transition period during which the ordering of society began to take on a higher priority.”

As you know, we have been following the sentiment indicators more closely than usual for many months. Initially our interest was piqued by the unsupportive readings despite much damage to stock prices (reading showing negative sentiment are positive for stocks). Now our interest is even stronger, because the market is so emotional. The put/call open interest indicator we follow has improved to neutral. Nearly all others have become squarely bullish. We discount these hard numbers for the various rumors and external events that may move the markets now, but, if those concerns were not present, the sentiment side of things (as of the second week in October) would suggest a firm if not powerful rising trend. □

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. Number of accounts in the composite as of 9/30/01 was 279, which represents 93% of total assets managed in this strategy with a measure of dispersion of 0.27. Inception of the composite was September of 1991.

Alpha-Based Strategies: 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 the preceding quarter. The number of accounts in the composite as of 9/30/01 was 28, which represent 27% of total assets managed in this strategy with a measure of dispersion of 1.13. Miller/Howard Investments has prepared all performance results. Inception of the composite was 3/31/97.

SELECTED INDICES

| | 3 rd Qtr'01 | 12Mo |
|---------------------|------------------------|---------|
| S&P 500 | (14.68) | (26.62) |
| Equity Inc | (10.10) | (9.25) |
| Util Fund | (12.32) | (23.08) |
| DJUA | (15.26) | (21.69) |
| LB Treas | 6.73 | 13.98 |
| LBGC | 4.76 | 13.17 |
| S&P 400 | (16.57) | (19.00) |
| Value Line | (22.22) | (25.91) |
| Rus 2000 | (20.79) | (21.13) |
| Rus 2000 Val | (13.33) | 5.61 |

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

Last quarter we expressed optimism about our BTB/Utilities portfolio, though we stopped short of pounding the table. In July, however, we sent a memo to consultants and advisors with whom we work, outlining our thinking that some further softness in pricing had brought our stocks back to a level of potential not seen since our previous memos in June of 1994 and January of 2001. A really sour broad market in August leading up to the horrors of September 11th combined to intervene in our scenario, yielding a down quarter that was sharp for us though mild compared to the rest of the investment world. But the elements we've been citing for several months now continue as before, and a sharp rally in our stocks during the first week of the new quarter (as we write) indicates that we aren't alone in our evaluation.

PORTFOLIO HIGHLIGHTS

After dragging down returns for nearly two years, the telecom portion of our portfolio is finally gaining some respect among investors (indeed, SBC Communications, BellSouth, Sprint, Worldcom, and Verizon, were all up for the quarter, among the few stocks of any kind that rose during the period). The RBOC's or Baby Bells, in particular, are in a terrific position: they've beaten off the competition, they have ample financing, capital expenditures can moderate due to reduced competition, and new unregulated services such as long distance, wireless, and DSL broadband can be sold to their vast hoards of virtually captive customers. Maybe their incumbent entrenchment is unfair, but these companies are in the catbird's seat to provide one of the higher growth essential services.

Meanwhile, gas-related stocks have played the unaccustomed role of spoiler, suffering through

a nearly 80% decline in the price of natural gas, after last year's fly-up. Gas demand has slowed due to a softening economy and unusually moderate weather this summer across the country, to be sure, and there are abnormally high levels of gas in storage now. But the long-term case for gas demand has never been stronger: essentially all new home construction uses gas for heating, and essentially all of the new electric plants which have been or are being built to solve our electricity shortage are gas fired. As these new homes and new plants come online, joined by industrial users when the economy begins to pick up, demand will be higher than ever before. Yet, despite record-breaking drilling for the past few years, supply only rose 1% last year. The fading of old fields is matching the development of new ones. And now drilling has begun to slow as well. As we've said, there is a kind of pressure cooker building here, and it will not be long before gas-related issues begin to contribute to performance once again, as they have for years.

Even without a notable recovery in gas prices these issues should do better. Valuations haven't been so modest in years, and in many cases the companies sell at P/E ratios below even reduced expectations for growth. This is a rarity in our experience, and unlikely to persist. Names like El Paso and Williams and Questar and Keyspan will show up on our leaders list before long, and we are heavily weighted in them.

What about electricity? Here too, the picture suffers a bit from current economic softness, but the underlying fundamentals have actually improved. We noted last quarter that even as

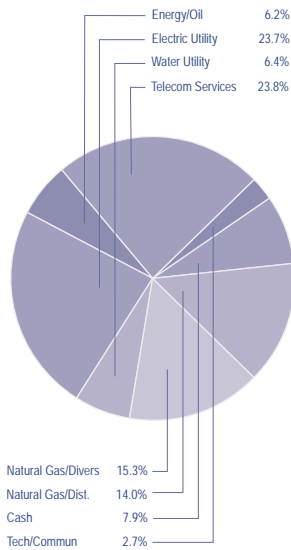
"As we've said, there is a kind of pressure cooker building here, and it will not be long before gas-related issues begin to contribute to performance once again, as they have for years."

| Quarter Composite Net of Fees* | |
|--------------------------------|----------|
| BTB/Util (Preliminary) | (7.97)% |
| DJUA (total return)* | (15.26)% |
| LBGC* | 4.76% |
| Ave Util Fund* | (12.32)% |

| 12 Month Composite Net of Fees* | |
|---------------------------------|----------|
| BTB/Util (Preliminary) | (10.44)% |
| DJUA (total return)* | (21.69)% |
| LBGC* | 13.17% |
| Ave Util Fund* | (23.08)% |

| 5 Year Composite Net of Fees* | |
|-------------------------------|--------|
| BTB/Util (Preliminary) | 12.68% |
| DJUA (total return)* | 11.14% |
| LBGC* | 8.00% |
| Ave Util Fund* | 9.56% |

*See Performance Disclosure on page 2.



Californians moaned and groaned, and the media frothed lurid with stories about the so-called electricity crisis and shortage, the fever had already broken and the situation was already healing. Aided by temperate weather which did not require as much air conditioning as normal this summer, and notable conservation among residents, as well as the addition of some new plants, California's power costs have dropped by 80% from winter averages, and are even coming into line with costs elsewhere in the country.

Paradoxically, the drop in prices is actually a positive for the power production industry generally, since it tends to let some air out of the "building bubble." There were far more plants on the drawing board than were needed in this country, attracted by the high commodity prices. But of course if all the planned plants were built there would be a glut of power (we've seen what can happen to companies creating a glut, as witnessed in the long haul fiber optic industry over the past few years), prices would tumble, and no one would profit. This possibility is what caused us to turn negative on the independent power producers late last year, when many investors were just discovering them as the "new growth stocks." Since then these companies have fallen 50-70% and, in the process, become quite cheap and attractive. Recently, Reliant Resources made a takeover offer for Orion Power (which was the independent power spin-off from Constellation Energy, formerly Baltimore Gas and Electric—you need a scorecard nowadays). Why? Stock prices have become so low that it is cheaper to buy a power company than to build new plants! We recently added NRG to our portfolio, at a price which reflects about 40% of replacement value of mostly new plants.

The potential for a glut still exists, but it has been rather fully discounted in this new group

of candidates for our portfolio, we think. The independent power producers are neither the high growth companies that investors hoped for in earlier times, nor, at current prices, are they the disasters waiting to happen that investment Cassandras may want to proclaim just now. Bear in mind that electricity is not like chemicals or paper: demand may have some cyclical, but it is not a cyclical industry. The risk here of course is that companies do not exercise fiscal or strategic discipline in constructing plants, but at least the risk is not in the end user marketplace. For we always need to turn on the lights.

Actually, in these times when investors have greater than normal feelings of uncertainty about the future (of course the future is always uncertain to some extent, so anxiety about that aspect must always be part of the investment equation), it is well to remember that electricity, as well as all utility services, have an *asymmetrical* relationship to overall economic expansion or contraction. That is, demand for the service grows when the economy expands, but it only grows more slowly when the economy contracts, rather than actually contracting along with the economy. There is a baseline below which growth does not slow, even when the economy posts negative numbers. In fact, since 1970 there has only been one year—1982—when electricity demand showed negative growth. We blame that one on a unique moment: Jimmy Carter and his cardigan sweaters!

We actually had some good news in the portfolio this quarter. American Water Works, the largest U.S. water company but one which we noted on a number of occasions would be no more than an inhale for a major European company, has received an offer of \$46 from RWE of Germany (the stock was about \$34, near an all-time high, when the offer came in).

UTILITIES PORTFOLIO CHARACTERISTICS

| | |
|---------------------------|-----------|
| Beta* | 0.46 |
| Dividend Payout | 53.48% |
| Sharpe Ratio | 0.64 |
| Projected Dividend Growth | 4.37% |
| Treynor Ratio* | 15.19 |
| Current Yield | 3.61% |
| Annualized STD | 10.95 |
| Market Cap (MDN) | \$4.7 Bil |
| Price/Book | 1.87 |
| Quality (Equity Rating) | B++ |
| P/E Ratio (MDN) | 12.72 |

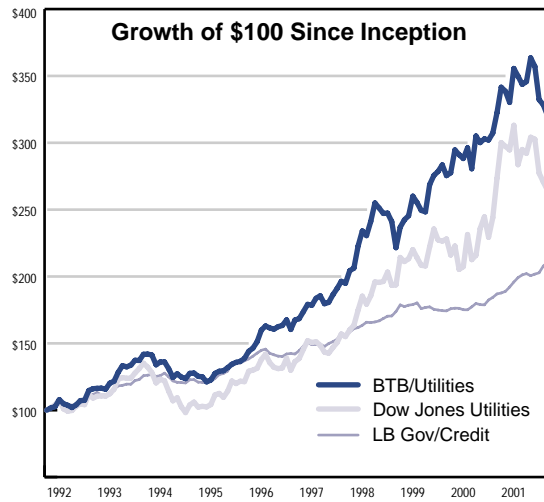
*Relative to S&P500, 9/30/91-9/30/01

This is a full-price offer and we doubt anyone will come in higher, though one can't count the French completely out. Also on the takeover front, our position in GPU finally ripened (after a few hair-raising episodes of doubt by other investors). We sold in the open market for a total return of about 30% (from first purchases, including dividends) which, given these past twelve months, looks like a quiet home run. We didn't take First Energy (the acquirer) stock, because FE operates nuclear plants. For a while there some politicians seemed more willing than ever to ignore the risks of nuclear plants, even calling for the construction of new ones. Then came September 11.

LOOKING FORWARD

We have been expressing optimism, and it is not whistling past the graveyard, but an extension of the same optimism that had been growing in us some months ago as the ducks in our portfolio began to line up and the excesses of the large-cap utility market (in which we have little participation) seemed to be nearly worked off. Life has twisted and turned along the way, but our approach has always kept its eyes glued to the far horizon and the reality that humans cannot live without utility services. We don't change our underlying views to fit the moment, but our optimism about future returns does indeed rise when events conspire to cheapen the prices of our stocks in relation to the long-term prospects for real-world success of the companies we hold.

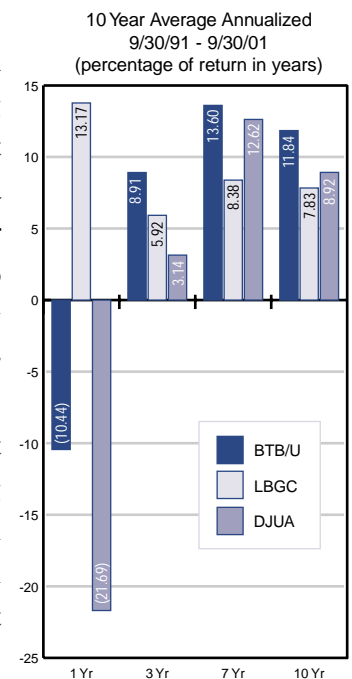
Having said that, and having noted our commitment to the eternal verities that have led to the outstanding absolute and risk-adjusted returns offered by this portfolio since inception, we also feel it's important—generally, for investors, at least—to remain alert to the possibility of the new. As we mention in the Overview, there are some open questions. Will



"Life has twisted and turned along the way, but our approach has always kept its eyes glued to the far horizon and the reality that humans cannot live without utility services."

our stocks be forced to spend much more on security than in the past? Will they be able to recover such costs? Are all of the security risks of our companies insurable? What happens if supplies are curtailed for a producer or distributor? Will the waves of liquidity being injected into the economy, waves which will eventually reach the equity market, reach our stocks in equal measure? Will investors pay more now for the stability of "real" companies such as ours? More for reliable dividends? Or less, requiring a greater risk premium to make any equity investment at all?

Like many things in life today, these are open questions. But so far, we find investors coming back to our stocks with an enthusiasm that certainly transcends short covering. California and the excesses in the large-caps are no longer a cloud. When America's factories begin to replenish what have become historically low inventories, company managements will *make a call*. They will ask to speak to the foreman. *Turn on the lights*, they will say. And that sweet river of electrons will become a raging torrent. *Now turn on the furnace*, they will say. And the pleasantly hissing pipeline will transmit a thunderous pressure. This is what we invest in. Talk. Energy in a wire. And Fire. They aren't going away anytime soon. □

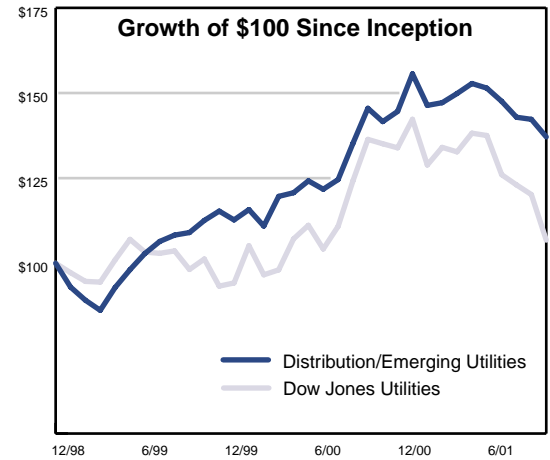


“Utilities generally have become oversold and undervalued, so the “utility-environment” factor should fade in importance.”

We’ve mentioned on a number of occasions that in the absence of consolidation or convergence transactions—which are the target or goal of this portfolio—our stocks are influenced by the general movements in the utilities markets as measured by the major utility indices. Although this should really not be the case, since these companies are not subject to the same market forces as are, for example, the power generation companies, it is nevertheless a fact. And while we had some positive news regarding several stocks in the portfolio, one of the worst quarters in history for utilities was a force too overwhelming for our stocks to resist. As one might expect, our portfolio was far less volatile on the downside than the indices, but, as they say, you can’t eat relative performance; we experienced our first significant down quarter since inception at the end of 1998.

PORTFOLIO HIGHLIGHTS

There was some positive news, in the midst of generally difficult conditions. Our position in American Water Works became the object of a friendly takeover offer from RWE of Germany, at a significant premium to prevailing market prices. While many perceived AWK as an acquirer—which it has been—the company is relatively small compared to European utilities with an interest in water, and it represented, in our view, a quick entrée into the American market. Frankly, we’re surprised that the French water companies didn’t get involved first. The current offer is sufficiently rich for us to doubt that a better number will come in, but there remains some gap between the offer price and the current market (reflecting primarily the time it will take to obtain all



regulatory approvals); we’ll hold on for a while—since we believe there is little or no impediment to the deal already on the table. There’s always the chance that the French will refuse to be closed out of the U.S. market.

We sold GPU for a total return of more than 32% in 13 months, receiving somewhat more than FirstEnergy’s original offer as our reward for suffering additional gray hairs during the holding period—there were several volatile moments when investors fretted about this deal over the course of our holding period. We sold Western Resources when it became apparent there would be no deal from offerer KCPL due to the difficult hurdles put in place by Kansas regulators. Having bought it right we still earned close to 20%, but were disappointed the outcome was not better, since we continue to view the company as substantially undervalued. Toward the end of the quarter we added Oneok. Western Resources holds more than 40% of OKE, and in order to sell themselves it’s highly possible they will have to divest their OKE stake, which would put OKE in play—as it should be already, due to its remarkably low valuation and attractive assets. We also took profits in Connectiv for a

| |
|--|
| Quarter Composite Net of Fees* |
| Distribution (Preliminary) (7.07)% |
| DJUA (total return)* (15.26)% |
| |
| 12 Month Composite Net of Fees* |
| Distribution (Preliminary) (5.75)% |
| DJUA (total return)* (21.69)% |
| |
| 2 Year Composite Net of Fees* |
| Distribution (Preliminary) 12.18% |
| DJUA (total return)* 4.30% |

*See Performance Disclosure on page 7.

total return of about 30% since our purchase in January of this year—there was almost no gap between the market price and the offer price from Potomac Electric, and we had other uses for the funds.

In addition to Oneok, we bought Cinergy on some price softness. This is a low-cost producer and prime consolidation candidate, an untroubled company that would fit well with its neighbors in every direction, particularly National Power, which controls Kentucky to the South, or FirstEnergy, which has already shown it's acquisitive stripes, to the North. We bought Cornerstone Energy when it crashed and burned on a bad earnings report. The world of propane distribution is filled with companies that grow through acquisition, and in the meantime the MLP's general partner, Northwestern, will have no trouble keeping the company—and its financial interest—afloat. We added to our Niagara Mohawk position, as the evolution of their deal with National Grid has become clearer and more positive. While there is a bit of risk since the deal is tied to National Grid's stock price, which has slumped, the deal itself looks greenlighted to us, and we had a chance to add an additional profit of about 15% to our position in a couple of months. Finally, we added Century Telecom. ALLTEL has offered \$43 per share for the company, but Century has balked. We've followed Century for many years, and felt that at the current market price (low 30's) it was modestly valued. But in light of the fact that a respected company in the industry has already told us in their first bargaining shot that the company is worth at least \$43, it was a mandatory purchase. If there's no deal we'll be content to own CTL at our basis, both on its own and as a marriage

candidate for another suitor. But our best guess is that a deal is made here, at 10% or more than ALLTEL has already offered.

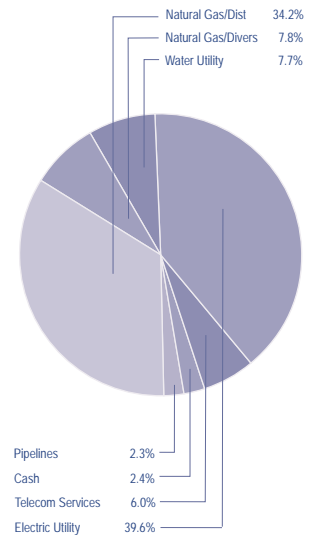
LOOKING FORWARD

We continue to wait like the bums in *Godot*, for the repeal of PUHCA. This legislation from the 1930's inhibits transactions in the industry and cools the ambitions of potential non-industry participants such as oil companies or investors like Warren Buffet (who's proclaimed his amorous desires—but only after repeal). We're following the action in Washington closely, and now believe that comprehensive energy legislation—to which repeal will be attached—won't appear until the first quarter of 2002. Much has been put on hold by the legislative branch as our country deals with its current crisis, but there does still seem to be plenty of enthusiasm in both houses to get an energy bill passed as soon as possible.

Meanwhile, we doubt this portfolio will sustain further damage. Utilities generally have become oversold and undervalued, so the "utility-environment" factor should fade in importance. And where else today do you get 4%+ plus yield which rises yearly, highly visible earnings, and imbedded potential takeover premiums of 30-80% for each and every position in the portfolio? □

Performance Disclosure

Distribution: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in composite as of 9/30/01 was 22, which represents 98% of total assets managed in this strategy with a measure of dispersion of .12. Inception of the Distribution composite was December of 1998.



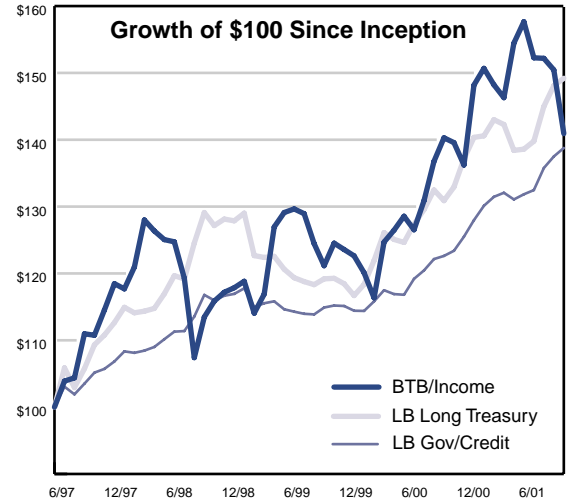
FUNDAMENTAL CHARACTERISTICS

| | |
|-------------------------|-----------|
| Yield | 4.33% |
| Proj Div Gro | 4.18% |
| Payout Ratio | 61.77% |
| Market Cap (MDN) | \$1.4 Bil |
| Price/Book | 1.43 |
| P/E Ratio (MDN) | 12.96 |
| Quality (Equity Rating) | B++ |
| Beta* | 0.15 |

*Relative to S&P 500,
9/30/99-9/30/01

"We note that MMR...has rated us as the least volatile of any equity portfolio in their universe of some 800 managers."

This portfolio was touched along with all other equity strategies, but the damage was relatively mild. It's not much of a stretch to say that for the quarter as well as for the year, BTB/Income has been better than just about any equity approach—though we uncharacteristically came in well behind fixed income, which played its occasional role as a safety zone this time around. In the first week of the new quarter our stocks have rallied back and erased about half of the 3rd quarter's losses, so there's reason to be optimistic that our portfolio, like the troubled world in which it now exists, is getting back to normal. With few exceptions our companies thrive on recurring revenues by provisioning the necessities and near-necessities of life. By definition, their underlying businesses are the most stable in the economy. And we did not hold any issues that suffered a direct negative impact from the tragic event of September 11 and its aftermath.



definitely delicious for what must be the deviant streak in our character.

We also closed out our Lincoln National (PRIDES) at an 18-month total return of some 60%, since these securities were about to expire. And we sold Genuine Parts for a similar gain, believing the stock to be fully valued, and hoping to buy it again sometime later at a lower price.

PORTFOLIO HIGHLIGHTS

We finally closed out GPU at a 32% total return profit, selling in the open market since we would not take FirstEnergy shares due to its nuclear involvement. We're happy with this position beyond the fact that it was profitable: we actually purchased GPU after the takeover offer was announced. Our analysis, aided and abetted by a few years looking at utility stocks, deals, and regulators, was that the deal made sense and would go through. Investors seemed to think otherwise, leaving so much on the table that we just had to sit down and eat. Perhaps we got lucky, but we like to think that some measure of expertise was able to help us go against the crowd, and contrarian triumphs are

But with the sweet comes the sour. We sold Timken for a small loss, though we'd held it for nearly three years without satisfaction. Conditions in the industrial world are just too tough for even this outstanding and well-managed company and they're not close to earning the dividend, which we think is in jeopardy. When the industrial world revives, we'll take a second look. Too, perhaps we erred last June in buying Ford. Where we thought we saw glimmerings of a bottom for the company, matters have only worsened. We admire management's forthrightness in admitting to the raft of problems facing the company now, but we really don't want to fight the competitive good fight alongside them in an environment

Quarter Composite Net of Fees*

| | |
|--------------------------|-------|
| BTB/Income (Preliminary) | 7.45% |
| LBGC | 4.76% |
| LB Long Treasury Index | 6.73% |

12 Mo Composite Net of Fees*

| | |
|--------------------------|--------|
| BTB/Income (Preliminary) | 0.46% |
| LBGC | 13.17% |
| LB Long Treasury Index | 13.98% |

3 Year Composite Net of Fees*

| | |
|--------------------------|-------|
| BTB/Income (Preliminary) | 7.50% |
| LBGC | 5.92% |
| LB Long Treasury Index | 4.93% |

*See Performance Disclosure on page 9.

which is sorely testing the consumer. The high dividend is now in doubt, and so are we; we'll have taken a short-term loss here by the time you read this.

We've recently added KeyCorp, the "snow-belt" bank to our portfolio, at a 5% yield. This was once one of the "hot" regional growth banks, and sold at nearly twice the price within the past few years. But a merger with Society Bank in Cleveland and various other forms of corporate indigestion threw a wrench in the gears, and earnings stopped matching its excellent set of assets. This year, a new CEO has entered the picture, cleaning up problems and adding fee-based services to the company's more than 900 branch locations. At 10 times next year's estimated earnings we think there's little risk. The dividend was increased this year—always one of our favorite signals from management, and there is substantial upside potential if a turnaround is effected. KEY sells at 1.5 times book, while premier regionals sell at 3 to 5 times book. The risk to reward ratio looks good here, and it yields more than the ten-year bond. These are the items we roam the market seeking.

We also bought some Morgan Stanley PERQS which essentially get us a high yield guaranteed by Morgan Stanley and a call on Qualcomm stock. Our position is tied to Qualcomm for 1.5 years, giving us participation in the appreciation (or its converse) with a yield in the mid-teens guaranteed by Morgan Stanley. Our first foray into these technology-connected securities—one tied to JDSU—has been an unmitigated disaster. But we have felt strongly that there should be some diversification into technology

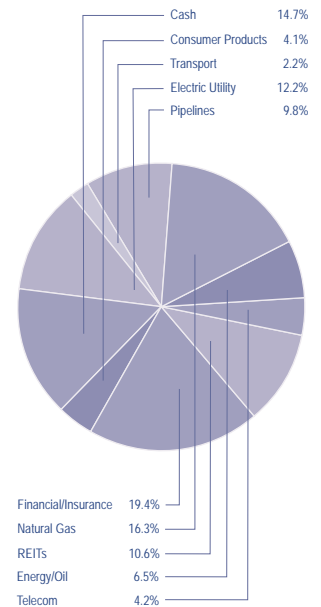
in this portfolio, and this or other convertibles are really the only way to do it. Recent quarters have not been kind to this idea, but at least we have kept our position size small—out of respect for the extra volatility of the underlying shares.

LOOKING FORWARD

We note that MMR (Money Manager Review), an organization that tracks private account managers similarly to Morningstar's tracking of mutual funds, has rated us as the *least volatile* of any equity portfolio in their universe of some 800 managers. Our defensive characteristics have been evident this year, especially in view of the fact that this portfolio has shown it can do as well as any on the upside. The fundamentals of our companies are sound; we've seen renewed buying as soon as market pressure was lifted. And our dividends continue to increase. So, though the world has become more uncertain generally, we have ample confidence that positive returns await in the near future. We noted in the overview that at some point down the road bonds are likely to prove a problematic asset class. But, as in 1998, we've already shown that our stocks can provide solid total returns even when rates begin to climb. The current yield on this portfolio is 7.72%, which is slightly inflated by a few synthetic securities with expiration dates, but is still realistically in the 7% vicinity. □

Performance Disclosure

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 9/30/01 was 62, which represents 52% of total assets managed in this strategy with a measure of dispersion of 0.66. Inception of the composite was May of 1997.



FUNDAMENTAL CHARACTERISTICS

| | |
|--------------------------------|-----------|
| Yield | 7.72% |
| Proj Div Gro | 5.53% |
| Payout Ratio | 67% |
| Market Cap (MDN) | \$3.2 Bil |
| Price/Book | 1.99 |
| Beta* | 0.46 |
| P/E Ratio** (MDN) | 12.63 |
| Quality (Equity Rating) | B++ |

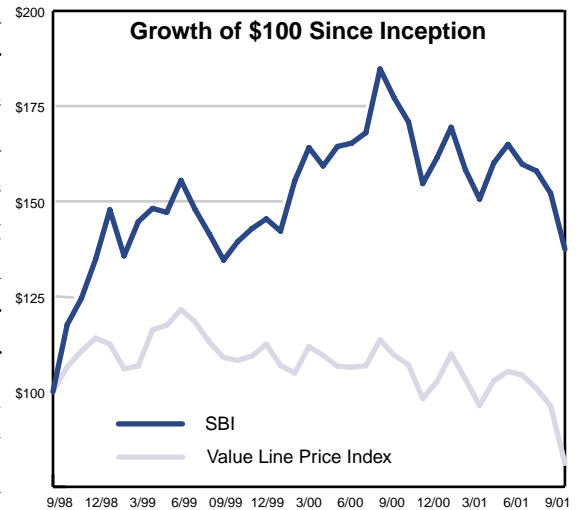
*Relative to S&P 500, 9/30/97-9/30/01
 **REITs use P/FFO ratio rather than P/E Ratio

"But changing your course in midstream isn't a prudent investment move, and surely we've seen enough investment flowers turn into birdseed in the past few years to understand that 'stories' are for children."

In the broader market uncertainty is anathema to investors. Hiding spots are few and far between since virtually every sector of the economy is likely to be affected. We face a new kind of enemy at the same time that we face an unresponsive economy, making tomorrow much more unpredictable, and making the economic struggle much tougher than usual. Drab economic figures, lackluster growth, and exponentially rising layoffs will surely be highlights of our times in the history books of future generations. Mercifully, such conditions don't last forever, so we continue to search for good stocks that are sound absolute investments.

Given the special circumstances of the moment, one could choose to remain on the sidelines, or try to chase every opportunity to capture speculative gains in defense, construction, virtual conferencing and surveillance, even funeral services – sectors that are all getting a boost due to the recent events... But changing your course in midstream isn't a prudent investment move, and surely we've seen enough investment flowers turn into birdseed in the past few years to understand that "stories" are for children. And fixed income, as we've noted, is going to be a zone of decapitation for investors as soon as the current wave of stimulus takes hold in the economy. The obvious course is to stay with the leaders and niche companies with extensive market shares, proven management, consistent historical growth rates and high financial strength—basically our typical SBI stocks.

While we couldn't avoid disappointments this quarter (the environment was tough all the way around), our portfolios were able to keep losses at bay for the last 3 months and year to date.



Relative to the S&P 500 index, which was down (14.68)% for the quarter and (20.39)% year-to-date, SBI composite net of fees declined by (13.98)% since June 30th and (14.91)% year-to-date. The strategy fared well yet again relative to most equity indices and funds.

PORTFOLIO HIGHLIGHTS

The overall fundamental attractiveness of the pharmaceutical sector—this is the most defensive area that also offers growth, in difficult times—led us to several portfolio changes in this area. AlphaPharma, a developer and manufacturer of generic and proprietary human and animal health products, was added to the portfolios after the announcement of its acquisition of a portion of an Australian generic drug manufacturer, Faulding. AlphaPharma's pre-deal valuation was attractive enough for us to get interested, but the potential for enhanced growth following the acquisition put ALO on top of the charts of generic drug producers in the US.

Searching for value in the pharmaceutical universe brought us another interesting

Quarter Composite Net of Fees*

| | |
|-------------------|----------|
| SBI (Preliminary) | (13.98)% |
| Value Line Index | (22.22)% |

12 Month Composite Net of Fees*

| | |
|-------------------|----------|
| SBI (Preliminary) | (22.48)% |
| Value Line Index | (25.91)% |

2 Year Composite Net of Fees*

| | |
|-------------------|---------|
| SBI (Preliminary) | 11.16% |
| Value Line Index | (6.72)% |

*See Performance Disclosure on page 11

candidate, Andrx Group, a developer of generic versions of selected controlled-release brand name pharmaceuticals. Although the stock in recent days experienced waves of excessive volatility due to investor concerns with the final FDA approval of Andrx's version of ulcer drug Prilosec, we believe that the company's core business franchise (including generic distribution, niche specialty products and proprietary pipelines) deserves a valuation at least 15-20% above current levels. In addition, generic Prilosec's potential could provide significant upside surprise to already rapidly growing (but modestly valued) earnings.

Along the same lines, we decided to swap Baxter for a new position in Merck. Basically, the risk/reward ratio had deteriorated for BAX, while it had greatly improved for MRK, which was temporarily out of favor with investors, but still a wonderful company. True, MRK growth may not be as stellar as in the recent past, but at a 5-year low P/E as well as at a discount to the S&P 500 the merchandise was irresistible.

We added a MediaOne preferred security, convertible into shares of Vodafone at what we thought was an exceptional price. VOD is a very familiar name to us: it's the largest wireless company in the world, with strong financials, and a client base of over 65 million globally. The convertible preferred represents an attractively priced equity surrogate that offers a yield of over 11%, a financial strength rating of A (one of the highest around), and quite high sensitivity to the underlying common.

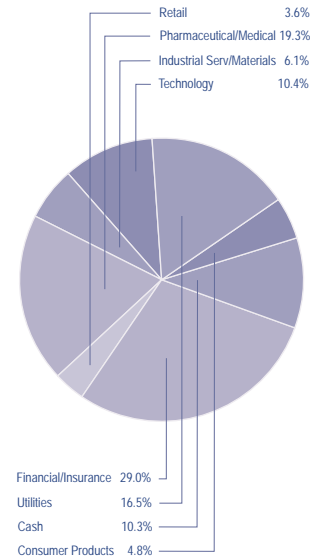
We also added SunGard Data Systems, whose business model fits the SBI investment profile almost ideally. The franchise factor is obvious, just about every financial services company under

the "sun" relies on their services. The company's investment support systems are used by anyone who's involved in securities trading and financial accounting. SunGard has 1% debt and highly reliable and consistent earnings growth. Estimated 20% growth at a P/E close to the S&P 500 makes it an appealing addition to our financial services industry group. Longer term it won't surprise us to see major intensification of transaction speed and volumes in the industry (like a push toward next day settlement) that will drive SunGard's business to record levels of revenue and profit growth.

On the sell side, we were able to take timely profits in Darden Restaurants—inspired by concerns about the state of consumers near term. We also trimmed Washington Mutual during the thrift shakeout in August. This gave us an opportunity for profit-taking and at the same time brought the weight of the stock back down to our typical allocation. We remain committed to the stock and find doubts about the ability of banks to generate profits in an environment of continuous cuts in the short-term rates unwarranted—though a softening economy is always a concern.

LOOKING FORWARD

Looking ahead, we'll be pushing toward achieving balance and quality among stocks in the portfolios. We are also trying to stick to the idea of sector-neutral investing which we find very appealing, though in the current environment there are some sectors that we will only move to...slowly. □



FUNDAMENTAL CHARACTERISTICS

| | |
|--------------------------------|-----------|
| Yield | 1.55% |
| Proj Div Gro | 11.96% |
| Payout Ratio | 11.33% |
| Market Cap (MDN) | \$6.4 Bil |
| Price/Book | 3.38 |
| P/E Ratio(MDN) | 17.69 |
| Quality (Equity Rating) | B++ |
| Beta* | 0.99 |
| STD | 21.17 |

*Relative to S&P 500
9/30/98-9/30/01

Performance Disclosure

SBI: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in the composite as of 9/30/01 was 10, which represents 87% of total assets managed in this strategy with a measure of dispersion of .66. Inception of the SBI composite was September of 1998.

FUNDAMENTAL CHARACTERISTICS

| | |
|------------------|-----------|
| P/E Ratio (MDN) | 13.86 |
| Market Cap (MDN) | \$500 Mil |
| Price/Book | 2.69 |
| LT Growth Rate | 25.45 |
| Beta* | 1.08 |
| R-SQR* | 0.44 |
| Annualized STD | 29.10 |
| Alpha* | 11.69 |

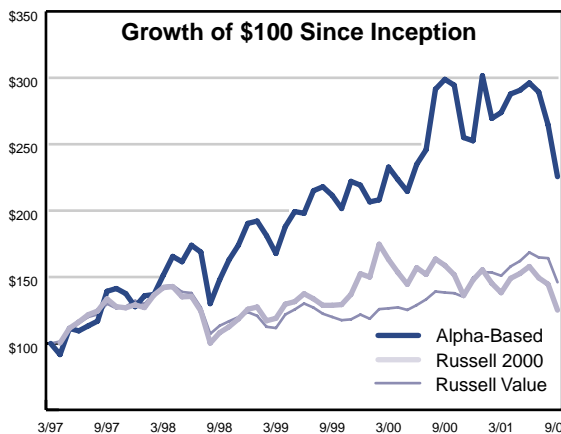
*Relative to S&P500, 9/30/97-9/30/01

The Alpha-Based Strategy certainly felt the blade of panicky downside volatility during the turmoil of September, and finished the quarter mildly worse than the Russell 2000 and noticeably worse than the Russell 2000 Value indices. That our results continue to rank among the best in the category for three years (we'll soon have five year numbers as well) barely removes the sting from this past period, though an absolute and relative performance surge in the first two weeks of the 4th quarter have proved a bit of a relief.

PORTFOLIO HIGHLIGHTS

Our underperformance this quarter didn't just come from the added volatility of the September market. We were slightly reeling from several blow-ups that occurred prior to the attacks. One of our top stocks from earlier periods, Carreker, reported disappointing earnings that discouraged Wall Street followers, and investors sold the stock off sharply. We took a risk with Polymedica. Often stocks are not bargains unless there is some controversy in the picture. PLMD had intimations of charges related to overbilling Medicare for nearly a year. We thought enough time had passed to warrant the view that whatever clouds there may have been had blown past. But, indeed, there are real problems. While the damage could have been worse, we bought the stock well and our flight from it produced a percentage loss that was depressing but not nearly as bad as it might have been.

Prior to the September 11 attacks, consumer spending was the only prop to the economy—although few would have rated it especially strong. It was natural that our portfolio would have gravitated in this direction, since in the consumer area we were able to find companies that were both cheap and had not disappointed on their growth promises. However, after September 11 the thesis that the consumer area was a good place to be came roundly into question, and we found ourselves needing to trim

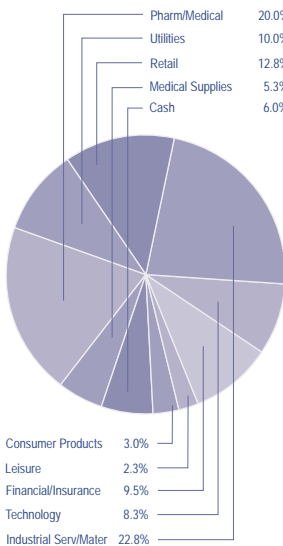


back our weight out of simple prudence. We came out flat in O'Charleys, but took jarring losses in J.Jill and American Eagle Outfitters. We replaced them with more defensive issues such as Fleming, a food distributor, and Option Care, a specialty drug distributor.

Though pockets of strength were few and far between for any strategy this quarter, we did have a few nice positives. Vesta Insurance Group, a high flyer of some years ago now on the rebound, gave us a 20% gain. Drug-related Alpharma and Syncor also provided some positive offense, as did Option Care and a renewed foray into Sunrise Assisted (which we sold profitably earlier in the year) has also yielded initial success. In August we beefed up our stake in Christopher and Banks and, since then, it is some 25% higher.

LOOKING FORWARD

We feel confident about our strategy and its implementation—and our team is always working on ways to improve it. With 20/20 hindsight we see that a more cautious posture would have worked better during the third quarter. The stocks we hold have not really disappointed us on fundamentals, and as we go to press their price charts are exciting almost across the board. This combined with a much more stimulative economy is likely to produce much better results during the fourth quarter. □



Quarter Composite Net of Fees*

| | |
|----------------------|----------|
| Alpha-Based (Prelim) | (23.84)% |
| Russell 2000 Value | (13.33)% |
| Russell 2000 | (20.79)% |

12 Month Composite Net of Fees*

| | |
|----------------------|----------|
| Alpha-Based (Prelim) | (24.42)% |
| Russell 2000 Value | 5.61% |
| Russell 2000 | (21.13)% |

3 Year Composite Net of Fees*

| | |
|----------------------|--------|
| Alpha-Based (Prelim) | 15.16% |
| Russell 2000 Value | 8.84% |
| Russell 2000 | 5.02% |

*See Disclosure on page 2