Miller/Howard
INVESTMENTS, INC

THE STRATEGIES

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.

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.

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.

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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MARKET OVERVIEW

Last quarter we posed the question on everyone's mind: is it over yet? Looking at the broad market in an effort to answer that query, we found ten key points of interest. It may be instructive, here, about 20% lower than the indices were in June, to revisit those points and see what, if anything, has changed.

1) *The Fed is loose, and is not likely to tighten again soon.* We noted at the time that this loose stance has been a positive for stocks historically, and by logic it always will be. However, at this point the money supply is in decline, due to the lack of demand for funds. The Fed will likely loosen again, if only to keep up with market conditions in the economy which are, in a word, slow. What is typically a happy circumstance for equity investors has become now a looming question mark: if the economy is not doing better at these low rates, what's the matter?

2) *Investor confidence in corporate governance is at the lowest point since the 1930's.* Televised images of selected CEO's taking the "perp walk" notwithstanding, it is not our sense that this issue has waned yet. There just doesn't seem to be much that's visible to investors in the way of prophylactic or corrective measures. It's true that some laws have been passed, and there are new rules as well as a new code of ethics established in the energy industries, but a new accounting governing body is not yet established and the Wall Street firms will be weaseling out of their responsibilities for deceptive research practices with relatively minor fines unless NY Attorney General Elliott Spitzer (our new choice for President) has his way with pending lawsuits. The slow rebuilding of confidence could be a solid underpinning for stock prices going forward, but we would like to see more activity in this area.

3) *Quantitative measures of sentiment…[are]…inadequate to support an intermediate-term rally.* Despite the bombing on Wall Street during the past quarter, these measures (advisory sentiment, index put-call open interest, public/specialist short interest) actually have not shown much discernable improvement as of the end of the quarter. It is possible that this market decline has been so severe and so drawn out in duration that traditional thresholds may have moved, but we doubt it. From a technical sentiment standpoint, only a rise in skepticism—whether accompanying prices that are lower still, or as a response to a short-term rally—will provide stability and persistence to any future price firmness.

4) *Short-term options activity supports a short-term rally, as does the fact that both the indices and many if not most individual stocks are severely oversold.* Well, we got the short-term rally at the end of July, but it did not last past Labor Day. Conditions are similar today. Lots of puts are traded, especially on down days, volatility indices are at fear-inspired highs, and stocks (individuals, at least, if not the indices) are both over-sold and undervalued by quantitative measures. Too, July 23 was a classic high-volume reversal day which may have marked a bottom in pricing. As we write, the S&P 500 and the Dow Industrials are struggling to stay above those July lows, and by the time you read this the result of that struggle should be apparent. A material breeching of those lows would open up the possibility of another quarter similar to the one just past.

5) *Valuations support upward price adjustments in some sectors but not all.* Over the three months just past every industry except precious metals that had maintained high valuations have lost them. There is no fluff. The valuation picture is better than it has been in many years. But see #8.

6) *The dollar has weakened and may well have reversed its long-term uptrend.* In recent months we've been exposed to great debate about whether a weaker dollar is a good thing or a bad thing for our economy and our stocks. In our view, a weaker dollar may be good for our exporting companies, but it is bad for inflation, and a disincentive for foreign investors to buy dollar-denominated assets. Currently the dollar has flattened out at roughly parity to the Euro and seems stable, so this factor is neutral for now. Europe's economy is weak now, too, so currencies are not likely to play a big role in the visible future.

7) *The macro-environment has changed from peaceful prosperity to a kind of nervous struggle.* And, over recent months, it has morphed again, into one in which the rest of the world has begun to fear and loathe the US due to its arrogant and peremptory approach to Iraq. Maybe W. will go down in history as the last cowboy, the man who stood up against evil and did what was necessary, but right now, on account of his strategy, we don't know who our friends are. And we don't know if this Iraq strategy will precipitate a blowoff across the Arab world. Prior to Desert Storm investors were clearly way too anxious. Will this be a repeat, or has complacency led to hubris among the military? We'll know that soon enough, but what we do know now is that the macro-environment does not sport candy canes growing along garden walks under rainbows and sunshine.

8) *By fall, earnings comparisons will be much easier…and investors may once again be free to extrapolate limitless growth.* This is still true, but investors have focused recently on companies meeting or exceeding expectations, rather than how well they are doing compared to last year. Indeed, earnings estimates are coming down across every industry we can think of, save small-cap health. This means that on the one hand valuations are improving (as investors ignore year-over-year results in favor of a focus on near-term earnings targets), while on the other hand the P/E ratios investors are willing to tolerate are static to down, based on fear of a fragile economy. This results in a valuation tinder-box that will ignite when there is more confidence—and justified confidence—in future earnings. But that confidence is not there now, among analysts or investors. These are great conditions of negativity in which a bottom can grow—since surprise improvements cause investors to take a 180 degree turn—but so far the earnings

"This results in a valuation tinder-box that will ignite when there is more confidence— and justified confidence— in future earnings."

SELECTED INDICES

	3rd Qtr'02	12 Mo
S&P 500	(17.28)	(20.49)
Equity Inc	(16.84)	(17.04)
Util Fund	(17.72)	(29.85)
DJUA	(20.51)	(25.54)
LB Treas	12.07	14.57
LBGC	5.20	9.21
S&P 400	(16.55)	(4.70)
Value Line	(24.58)	(21.35)
Rus 2000	(21.40)	(9.30)
Rus 2000 Val	(21.29)	(1.47)

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

pessimists haven't been proven wrong. Without some growth, the dividend-discount models on which valuations are based can't yield high stock price targets.

9) *The old highs reflected a vastly different economic and sentimental framework, and can't be seen as targets in the visible future.* Very little is black and white in the world of investing, but we think the following is bankable: the nineties are gone.

10) *Corporate insiders have not been buyers…a negative factor for the six-month outlook.* In August the insider buy/sell numbers actually turned bullish for the first time in ages. In part this was a result of simply less insider selling (at such low prices!) causing the ratio to improve, but the buyers had definitely come out of hiding. Sad to say, this painkiller wore off quickly, and the insider numbers are back to neutral at best. This of course prompts any observer to ask if stocks are cheap enough yet.

So, overall, despite a stinging quarter, not much has changed. If anything, the uncertainties over Iraq and over the feeble response of the economy to low interest rates have left conditions a notch worse—although it is always better for buyers when stocks are cheaper. In a way, the best news in this review is that stocks *are* cheaper. Unlike a falling object in the physical world, the rate of descent for equities must slow as they get deeper into intrinsic value, or price-relative-to-future-earning-power. There is a strata of the market that gets excited by low prices, and they will show up to take "strong" long-term positions. The value-conscious investors are likely to put in a bottom soon, if they haven't already, and that leads us to envision only modest declines—even if the July low is broken—and some year-end firming. But to move stocks back up with any vigor, we'll need more help from points 1 through 10. ❑

BETTER THAN BONDS | UTILITIES

Although there were still a couple of flare-ups in our portfolio during the quarter, it appears the fires which swept through the utility sector over the past year have died down. Companies have retreated from diversification efforts and gone "back to basics"— from strategies that failed as a result of inadequate capitalization, too much competition, and extremely volatile commodity markets resolving finally in unexpectedly low prices. That all this occurred in the midst of several high-profile "headline" cases of fraud completed a nightmare scenario, and utilities generally completed their worst quarter and year-to-date since 1974. Even the royal Duke Energy fell by half. We outperformed the Dow Jones Utilities this quarter, though that was not much consolation.

"Even the royal Duke Energy fell by half."

PORTFOLIO HIGHLIGHTS

The pattern of return attribution remained as it has been for the year: only moderate price change among distribution stocks and traditional companies in traditional businesses, negative volatility among telephones (including surprisingly bad showings by the Baby Bells) and companies pulling back from forays into generation or merchant activities.

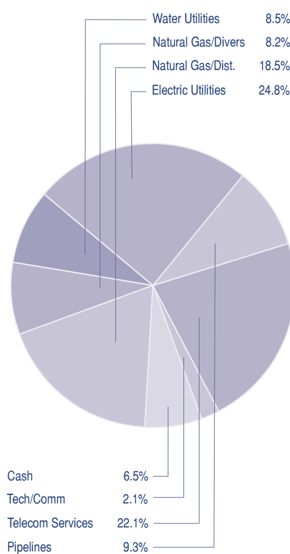
Our largest weight, Kinder Morgan Energy Partners, actually had a positive return for the quarter, which puts it in very select company. Our new addition, Philadelphia Suburban, a water distribution company which basically replaces American Water Works (being taken over by the German company RWE) also

Quarter Composite Net of Fees*	
BTB/Util (Preliminary)	(19.98)%
DJUA (total return)	(20.51)%
LBGC	5.70%
Ave Util Fund	(17.72)%

12 Month Composite Net of Fees*	
BTB/Util (Preliminary)	(38.03)%
DJUA (total return)	(25.54)%
LBGC	9.21%
Ave Util Fund	(29.85)%

10 Year Composite Net of Fees*	
BTB/Util (Preliminary)	4.77%
DJUA (total return)	4.72%
LBGC	7.44%
Ave Util Fund	4.74%

*See Performance Disclosure on page 12.



UTILITIES PORTFOLIO CHARACTERISTICS

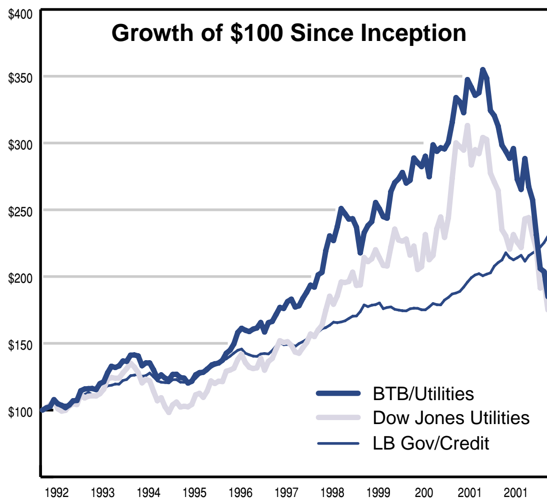
Beta*	0.56
Dividend Payout	53.69%
Sharpe Ratio	0.05
Proj Dividend Growth	3.66%
Treynor Ratio*	(0.41)
Current Yield	5.07%
Annualized STD	13.18
Market Cap (MDN)	$2.2 Bil
Price/Book	1.62
Quality (Equity Rating)	A
P/E Ratio (MDN)	11.46

**Relative to S&P500, 9/30/92 - 9/30/02*

contributed a positive return since our purchase in mid-July. Questar, which is benefiting from both its stable utility operations and a gradual rise in the price of natural gas (up over 27% since the end of June), was only mildly negative, as were gas distributors Peoples Energy, AGL (Atlanta Gas Light), Atmos, and IdaCorp (which has pulled back from a minor adventure in trading, and is one of the few stocks among US equities with a "positive" credit outlook from Standard and Poor's).

The Baby Bells have lost fans, as line growth has stalled or gone negative for nearly two years now. The economy has taken its toll, especially in the small business phone segment, and technology substitution is cutting into line growth as well—some subscribers have switched to wireless entirely, or to bundles offered by competitors that offer local as well as long distance for "one low rate." Our concern for some time has been the negative potential of an improvement in VOIP technology (voice over the internet), which would cut into revenue growth. New developments also pose risks in terms of technology substitution: the first successful Powerline Communication tests have recently been completed in this country, by legitimate players including Progress Energy. This technology would use electric lines—which are ubiquitous worldwide—as the broadband "last mile" for local connection, a fat highway on which all communications including entertainment could ride. The technology is already in the first stages of commercial roll-out in Europe, which has an easier infrastructure in terms of implementation. The Bells are cheap and yield well now, but we need to re-think our weights in view of the apparent frictional elements relevant to their future growth. On the other hand, our electric distributors are definitely the interesting dark horse in telecommunications, of all things.

We had angst with Williams, Aquila, and El Paso. The first two lost their credit ratings to the accompaniment of prevarication, contradiction of earlier statements, and failure to do what they said they would. Implementing some of the points listed later on in this report, we felt we needed to stand aside until there was a clear and secure investment situation, notwithstanding our chagrin at having waited so long. We try to temper that chagrin by reminding ourselves that we had been misled, but it doesn't help much. El Paso was a deep disappointment. Having fixed its financial structure in 2001 and with a frequently re-iterated (by the credit agencies) BBB+ rating, asset heavy El Paso seemed to a be a prime candidate for "last man standing" in the gas and electric sector. 60,000 miles of pipeline and the 4th largest gas production operation in the country qualified it as asset-heavy, the anti-Enron. We had considered raising our weight in the stock, but wanted to wait until after a FERC administrative law hearing on capacity constraint was completed. This hearing seemed a pro-forma affair, since El Paso had twice before been exonerated of the same charges by the same judge, but California politicians persisted in insisting on yet another hearing, and this one appeared to be a kind of charade to mollify them. To the surprise of nearly all observers, this time Chief Judge Curtis Wagner found, based on "new evidence", that El Paso had withheld capacity from California, thus raising gas prices and consequently electricity prices, during that state's energy crisis. We read the entire decision within minutes of release, and saw no point in arguing (although there are plenty of arguments to make). There is potential for a cascade of civil actions as well as reimbursements to the state and fines to the FERC, plus there is even certification risk, so we sold our relatively modest position and will stand aside until there is both safety and clarity here.



We don't want to spend too much time fighting a war that may be over. As you know, we believe that various new laws relating to corporate governance and rules from the FERC, as well as the chastening effect of business failures already experienced, will go far toward making companies in our sector as well as all sectors much more transparent and credible—in a way, stronger than ever. But we never want to have a year like the one that's just transpired ever again, and we never want to have a stock "snooker" us ever again. To that end, we've adopted seven principles as Risk Controls for our BTB portfolios. There is not room to print all the detail about each principle here, but you can find the complete statement on our website www.mhinvest.com:

1) "Zero-tolerance" for accounting irregularities, corporate mendacity or contradiction, attempts to obscure the true operating or financial condition.
2) Focus on credit market treatment. The agencies and analysts are too late and too conflicted. Bond buyers are cold-eyed and astute about potential financial extremes.
3) Maintain a strong focus on commodity prices first and foremost for companies that are involved in power generation, gas production, or marketing.
4) "Stand aside." Often the long-term case for investment in a company may be strong, but current events or circumstances may make the stock too risky. "Stand aside" has a different viewpoint and psychology than "sell."
5) Focus on regulated utilities. There are not so many companies in this world who can maintain a consistent return on equity of 10-12%. Traditional utilities have a great long-term record and their position in the world is secure.
6) Consider the technical picture. Our stocks and all stocks have become more volatile and quicker to change favor in recent years. Our firm began as a quantitative technical research boutique, and while in the past our main pricing focus has been relative to valuation (and buying stocks at apparent bottoms), in the future we believe technical tools may be increasingly appropriate, even in the utility sector. Over the past year, inexplicable technical breakdowns have presaged further difficulties.
7) No new lingo, no new metrics. New language maneuvers have accompanied each instance of financial marketing and chicanery. We will assume in our sector there are no new businesses, no new accounting concepts, and arithmetic remains arithmetic.

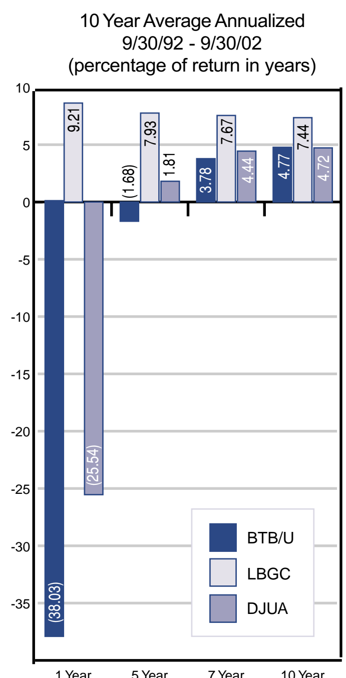
Again, we expect these businesses to revert to their earlier clean and dowdy nature in the future, but we insist to ourselves that we will never be blindsided again.

LOOKING FORWARD

Looking forward, we have to assume that a substantial rally may occur at any time, and without warning. Although our companies have grown over the years, valuations (P/E ratio, price/book, price/cash flow, etc) have never been skinnier in our experience. Simply a return

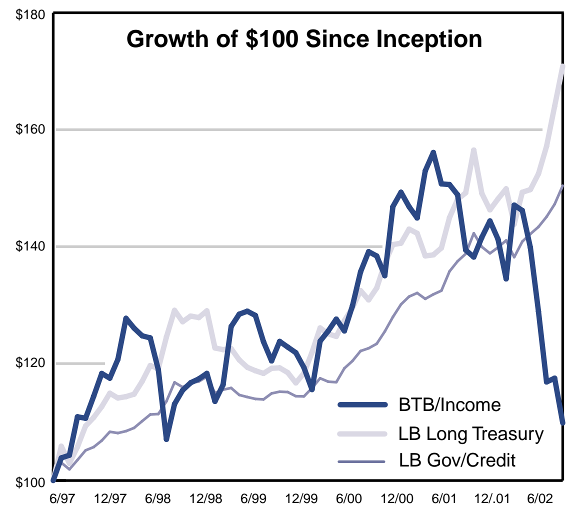
continued on page 12...

"...we've adopted seven principles as Risk Controls for our BTB portfolios."



"More and more we find investors and analysts warming to the notion of income in an equity portfolio."

Although we beat the S&P 500 for a second consecutive quarter, this recent period has tried the patience and frayed the nerves of even the most sanguine investors. While the "broad market" portion of the portfolio held up admirably, our exposure to the utilities sector – roughly 50% of the portfolio – continued to weigh on performance and inject some additional volatility. We recommend reading our BTB/Utilities piece to get a more in-depth explanation of why even the most conservative utilities have been out of favor. Despite the difficult operating environment and persistently negative market sentiment, several of our positions boosted their dividends and earnings have come in as expected.



PORTFOLIO HIGHLIGHTS

Earlier this quarter, spurred by threats of downgrades from the credit ratings agencies, many utilities were forced to embrace a "back to basics" restructuring program that would rid them of their highly volatile (and too often unprofitable) unregulated energy marketing and trading businesses. Unfortunately, even those utilities with long, conservative management histories, BBB+ or better credit ratings, and seemingly adequate assets and regulated cash flows/earnings could not withstand the forces sweeping the industry. Through a combination of poor timing, flawed business models, and insufficient character to confront their missteps in a timely fashion, the management teams of Williams and Aquila brought two venerable public utilities to their knees. While these companies may – in time – recover their financial footing, they no longer meet our basic criteria for inclusion in this portfolio, nor do they possess the credibility to merit tolerance of their sub-standard financials.

On the bright side, the broad market portion of the portfolio handily beat the S&P 500, posting only modest losses overall with a few positions ending the quarter in positive territory. Relative newcomer, Worthington Steel posted the strongest gains (6%) following their surprise 85% increase in quarterly earnings on improved demand for core products. At the moment, almost a quarter of the portfolio is invested in financials, including smaller regional banks and insurers. In addition to providing steady growth at a reasonable price, most of our holdings are also viewed as attractive consolidation candidates and currently trade at a significant discount to industry averages. In this vein, we recently began adding Community Bank System (CBU), a midcap bank holding company with a chain of community banks located in Upstate New York and Pennsylvania. CBU's current valuations are nearly identical to those of several recently acquired banks prior to their transaction, and, while we wait to see if a true consolidation trend materializes, we're content to collect CBU's rising dividend and 4% yield.

Another recent addition to the group is SPC E, St. Paul Companies convertible preferred class E. We added this property/

Quarter Composite Net of Fees*	
BTB/Income (Prelim)	(14.79)%
LBGC	5.70%
LB Long Treasury Index	14.51%

12 Mo Composite Net of Fees*	
BTB/Income (Prelim)	(21.22)%
LBGC	9.21%
LB Long Treasury Index	14.57%

3 Year Composite Net of Fees*	
BTB/Income (Prelim)	(3.02)%
LBGC	9.68%
LB Long Treasury Index	12.74%

**See Performance Disclosure on page 12.*

casualty insurer with a view that the challenges the company recently faced are likely to have been discounted by the market. In addition, at current levels the position provides high appreciation potential balanced by an attractive risk/reward profile, a current yield over 7% and high sensitivity to the underlying common.

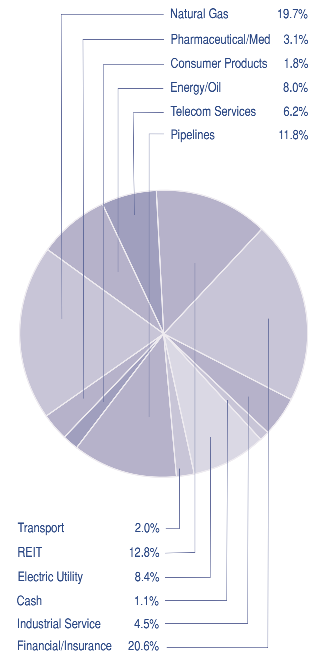
Expanding the diversification theme, we recently added contrarian positions in Schering-Plough and Toys "R" Us preferred A. We don't often come across a major pharmaceutical player with a solid balance sheet and an all-time high yield of almost 3% with historical dividend growth in the double digits, so we're excited about the prospects for SGP. In addition, rumors have been circulating that a deal is in the works, making the company a potential acquisition target as well. The Toys "R" Us convertible preferred, yielding 7.4%, is highly sensitive to the common stock, which in our view is capable of returning to peer valuations from a depressed level of 9x next year's earnings. In addition to its solid credit rating, the convertible offers better downside protection than the common while providing us with an opportunity to participate in the eventual comeback of the number two toy retailer in the country.

REITs traditionally played a significant role in our asset allocation due to their natural fit with the general characteristics of the strategy. At the moment, our weight is around 10%, although we remain cautious about increasing our exposure to this sector of the market. Our REITs are diversified among office, industrial, apartment sectors and, in general, include the most solid choices in the group. Our research process focuses on the financial strength of the company, as well as its pricing relative to the underlying value of the real estate assets. We also pay close attention to dividend payout ratios, debt distribution of the company as well as the macro picture of the markets where our REITs operate. With historically low mortgage rates feeding a boom in purchases of single-family homes, Equity Residential reported lower than expected Funds From Operations attributable to a slowdown in demand for apartments. Accordingly, we've started using EQR as a source of cash for new positions.

Other holdings include oil and gas master limited partnerships as well as high yielding equities in various sectors. Most companies we own (with the exception of the convertible preferreds — 18% of the portfolio) have a projected dividend growth of over 5% and historically have increased dividends at an annual rate of 5-6%. Indeed, several of our MLPs showed positive returns for the quarter.

LOOKING FORWARD

The overall valuation of the BTB/I portfolio is very compelling. Our median P/B and P/E ratios are 1.7x and 13.6x respectively compared to 31x for the S&P 500 index. The utility portion, which has been a drag on the portfolio since the beginning of the year, is also at the bottom of its historical valuation and we believe may provide considerable alpha in the coming quarters. More and more we find investors and analysts warming to the notion of income in an equity portfolio, which bodes well for our holdings. Current yield for the portfolio is a little above 7%. ❑



FUNDAMENTAL CHARACTERISTICS

Yield	7.27%
Proj Div Gro	5.23%
Payout Ratio	54.09%
Market Cap (MDN)	$2.1 Bil
Price/Book	1.96
Beta*	0.54
P/E Ratio(MDN)**	13.61
Quality (Equity Rating)	B++

**Relative to S&P 500, 9/30/97-9/30/02*
***REITs use P/FFO ratio rather than P/E Ratio*

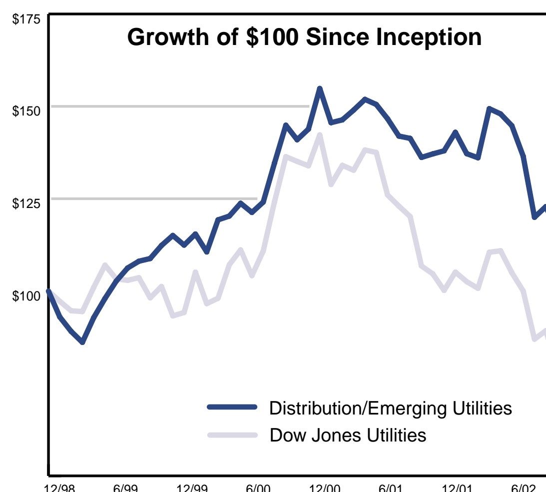
"...there are few niches in the equity universe that have done better than this portfolio for the quarter and year."

Third quarter didn't bring much relief to our area of the market as even plain vanilla distribution utilities experienced continued pressures of investor pessimism and negative sentiment surrounding the sector. Economic fears along with falling bond yields, uncertainty over Iraq, and industry specific headlines have built in large risk premiums into our group, affecting virtually every stock in the universe. Even so, there are few niches in the equity universe that have done better than this portfolio for the quarter and year.

While our portfolio by far outperformed the broad market for the quarter – down -14.55% (gross of fees) vs -17.28% for the S&P 500 and -20.51% for the DJU index respectively – we remain disappointed with increased levels of volatility. Nevertheless, we believe that with the most negative news surrounding energy players now out in the open, the old fashioned regulated monopolies (such as the companies in our portfolio) will revert to their regular trading patterns characterized by consistency of returns and low risk. It is also important to remember that even though we've recently experienced some hyperactivity in select issues, our investors are still receiving an almost 5% dividend yield even as the 10-year Treasuries are approaching the 3.7% level.

PORTFOLIO HIGHLIGHTS

As we mentioned in our BTB/Utilities report, we're paying increased attention to the underlying financials of our holdings, specifically interest coverage ratios (currently averaging approximately 3x), upcoming debt maturity, as well as yield spreads of corporate instruments issued by our holdings relative to Treasuries of



similar tenure. Our current average yield spread of 260 basis points for the portfolio reflects bondholder confidence in the credit stability of our holdings. As a reference point, public US utilities of similar rating are currently yielding slightly over 5%, with a yield spread of around 240 basis points, according to Bloomberg Fair Market sector curves.

We also have established a zero tolerance policy toward issues with credibility problems. As a result, early in the quarter we bit the bullet and got out of our positions in Williams and Xcel Energy. WMB management kept us on the hook too long with promises to aggressively sell various assets and exit energy trading by the end of July, and then failed to actually do anything, losing its investment-grade rating in the process. Though there are lots of physical assets there and this could be a great turnaround one day, we believe that the management is addicted to trading and the company no longer has the same takeover appeal as it did before (at least for public shareholders).

Xcel Energy earned a place in the portfolio as a solid north-Midwestern utility with a large regulated rate base and an honorable, long

Quarter Composite Net of Fees*	
Distribution (Prelim)	(14.77)%
DJUA (total return)	(20.51)%

12 Month Composite Net of Fees*	
Distribution (Prelim)	(14.57)%
DJUA (total return)	(25.54)%

3 Year Composite Net of Fees*	
Distribution (Prelim)	2.25%
DJUA (total return)	(6.78)%

*See Performance Disclosure on page 12.

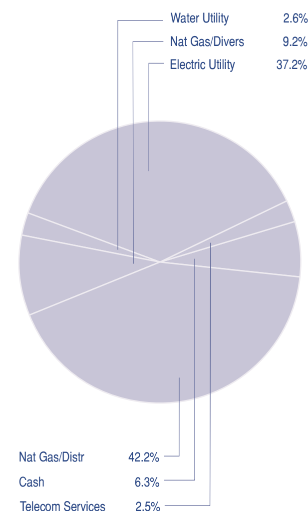
history. The stock had been dented a bit by its troubles with NRG, its unregulated generation subsidiary, of which it had spun off 20%. But things got so bad in the generation industry, and for NRG in particular, that default risks are now palpable for NRG. While XEL successfully re-negotiated its debt so it will not automatically cross-default should NRG fail to make payments or declare bankruptcy, NRG's woes remain highly problematic for XEL and are likely to linger. With the market showing no mercy for anything related to generation, and recognizing that we've witnessed the unthinkable come to pass more than once during this period, we decided to step aside until there's some clear resolution of these issues.

On the brighter side, even with no active deals in the public markets, our fundamental characteristics continue to be on the low end of historical valuations with an average P/E of 13x, P/B of 1.3 and BBB+ credit. The two deals completed this quarter, Potomac's purchase of Conectiv (which we held and sold earlier) and Energy East's acquisition of RGS (also a former holding which we sold prior to closing), went for an average Price/Book of 1.8x and about 3x stockholder equity – in line with what we consider fair valuation for our group.

In the current environment it may seem that regulated distribution companies with less volatile business models carry a bit of a premium when compared to the rest of the utility universe. Still, our holdings are strategically well positioned and continue to trade substantially below their private market value, making a strong case for future M&A opportunities in the portfolio. One of the examples of an ideal takeover profile is represented in our position in Northeast Utilities, a low-risk transmission and distribution operator with a mix of nonregulated generation businesses in New England states. Here we have a successful operator with a predictable revenue stream, strengthening balance sheet and overall financial profile and a well balanced business model that combines regulated operations with a mix of competitive generation in a rather "tight" supply area. Also, it's virtually the last remaining stand-alone distributor in Connecticut, with an established private market value of over $25 a share based upon a previous offer from ConEd. The others have already been purchased by larger companies.

LOOKING FORWARD

Even though we outperformed the broad market for the period, we are not satisfied with our recent performance—but we think the negative news is out. We're looking forward to a return to this portfolio's stable, boring, winning character. What might intervene is positive, however. Comprehensive energy bills passed by both the House and Senate are in conference committee even as we write, with both sides seemingly bent on achieving a compromise, and both sides favoring repeal of The Public Utility Holding Act. As repeal efforts have dragged on, asset and company prices have declined, resulting in an increasing stag line of suitors in the sector, now including: a number of private equity firms, Warren Buffet, two major German and two major British utilities, Chicago's Exelon, and First Energy, just to name some of the more important players. We'll be disappointed if repeal of PUCHA fails, although there are certainly many deals that can be done without it. And we'll be really surprised if repeal of PUCHA doesn't result in a plethora of deals, a symphony of deals. In fact, if it doesn't…we'll eat our hats! ❑



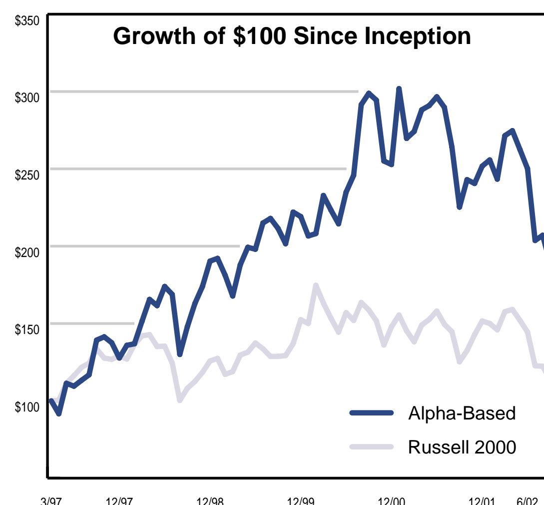
FUNDAMENTAL CHARACTERISTICS

Yield	4.78%
Proj Div Gro	2.65%
Payout Ratio	63.43%
Market Cap (MDN)	$1.1 Bil
Price/Book	1.49
P/E Ratio (MDN)	13.07
Quality (Equity Rating)	B++
Beta*	0.36
STD	15.73

**Relative to S&P 500, 9/30/99-9/30/02*

It hardly bears repeating that in the third quarter no sector of the market was safe from the overbearing negativity of investor sentiment and economic turbulence. Even small caps lost their absolute and relative winning streak as the broad picture deteriorated in mid to late July, driving the Russell 2000, the proxy for the small cap universe, down close to -22% for the quarter and -25% year to date. Our portfolios were dragged down—despite a lack of negative company-specific news— giving up gains in a rapid selloff across most industry sectors. While we are far from being satisfied with our performance, our portfolios, down -23.82% (gross of fees) for the year, are in the mid range of the small cap fund universe, with the average fund down -24% year to date.

"...in this market we won't be marrying any issues."



PORTFOLIO HIGHLIGHTS

The highlights of the quarter, in Russell and in our portfolio, were a couple select stocks and industry groups that managed to outperform the market with consistently low volatility. In general, healthcare-related stocks did better than the rest of the world. In early August, we increased the weight in US Oncology after successfully taking profits earlier in the year, and subsequently trimmed the position back to 4% after a few solid weeks of gains. The stock's superb relative strength and underlying fundamentals once again rewarded us with excellent relative performance for the period.

We also took partial profits in Prime Medical Services on a rally in mid-July, trimming our weight to 4% before the stock gave back previous gains in the market pullback. As of this writing our unrealized gains on the position are over 50% since initial purchase, and the news flow continues positive. In fact PMSI's recent acquisition of Smit Mobile Equipment, a leading European manufacturer of mobile medical imaging vehicles, will be immediately accretive to earnings, and is quite encouraging. However the story unfolds, though, in this market we won't be marrying any issues.

Lumenis continued its recovery from a series of bad news, by posting a 6% gain for the quarter. This maker of medical lasers, in addition to its low valuation and a recently granted FDA approval for light acne treatment devices, now stands to benefit from an increased use of the infamous anti-wrinkle Botox (as a complimentary treatment), a hot item among the vain of the world. We do realize that the stock still has to prove an ability to bring revenues down to the bottom line, but its resilience in the tough times such as ours augurs well.

Retailers hurt us this quarter with the average position down in the 20s, similar to the industry averages, as investors fled the sector on weakening consumer spending and negative sentiment surrounding the group. Our holdings are bouncing back nicely, though, and continue to report respectable same store sales and projections.

Quarter Composite Net of Fees*	
Alpha-Based (Prelim)	(24.53)%
Russell 2000	(21.40)%
12 Month Composite Net of Fees*	
Alpha-Based (Prelim)	(16.22)%
Russell 2000	(9.30)%
3 Year Composite Net of Fees*	
Alpha-Based (Prelim)	6.26%
Russell 2000	(3.19)%

*See Disclosure on page 12

Not everything was depressing this quarter. Take-Two, a consistent star this year, was a hit in the market as well as a hit among video game players. The stock managed to finish the quarter as the number 10 best performing stock in the Russell, gaining 40.85%. In addition to posting record-breaking quarterly earnings, TTWO recently raised annual guidance in the expectation that its highly anticipated sequel to blockbuster *Grand Theft Auto 3* will capture the number one ranking this holiday season. For anyone still unconvinced that video games merit investor attention, GTA 3 grossed $350 million so far this year . . .and Christmas is still ahead. Indeed, expectations for the sequel *GTA: Vice City* – narrated by Ray Liotta of Goodfellas fame – are so high, that TTWO and Sony Music Entertainment announced a deal to issue seven soundtrack albums based on the in-game radio stations, featuring artists such as Judas Priest, Blondie and Flock of Seagulls.

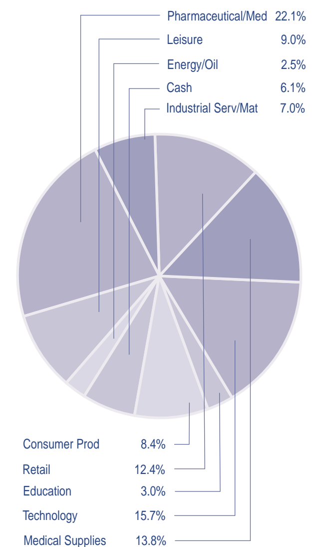
In mid August we took partial profits here as well, primarily on technicals. It remains our highest weight, though, and is still a value/GARP stock (trading at less than 15x forward earnings). With the potential for more sequels and rumors of possible movies based on *GTA 3* and/or *Max Payne* – TTWO should offer significant upside potential in the coming year.

As far as the new items in the portfolio, we've added several consumer names, including Buca, Chuck E. Cheese's and our old friend, Jakks Pacific. Buca and JAKK have been beaten down to ridiculous valuations, primarily as a result of weak consumer reports and the general economic background. But projections for growth here remain strong, in addition to tremendous insider buying on Buca's side. Also, from a top-down perspective, we don't particularly envision drastic spending reductions when it comes to inexpensive family-style dining, entertainment and action figure collectibles.

LOOKING FORWARD

Overall, we are encouraged by general valuations of our stocks, which continue to be impressive, with the averages still well below the market. Our forward P/Es and PEG ratios remain at classical levels that are fully in line with our stock picking criteria. Taking a macro view, since put/call ratios are not exactly pointing in support of a major rally, we are generally cautious and leery of the exceptional volatility which seems to be constantly laying in wait.

But this economy is good enough for selected individual companies to thrive, and when the pressure is off the equity markets, many should show fine gains quickly. Looking forward, in every area of the market the technical picture has become more important, as the market's oscillations are likely to be wide and frequent. Technicals have always played a large role in this portfolio, and we intend to be even more aggressive in applying our technical expertise – taking profits as they come and trading out of troubled positions on timely basis, as the public markets are likely to remain choppy in the upcoming quarter. ❑



FUNDAMENTAL CHARACTERISTICS

Forward P/E Ratio	16.11
Market Cap (MDN)	$210 Mil
Price/Book	2.14
LT Growth Rate	20.37
Beta*	1.07
R-SQR*	0.45
Annualized STD	29.08
Alpha*	10.78

**Relative to S&P500, 9/30/97 - 9/30/02*

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 100 basis points from gross of fees performance. A complete list of all the firm's composites is available. Returns are total returns and dividends are assumed to be reinvested. 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 9/30/02 was 263, which represents 95% of total assets managed in this strategy with a measure of dispersion of 0.82. Inception of the BTB/Utilities composite was September of 1991.

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 9/30/02 was 140, which represents 79% of total assets managed in this strategy with a measure of dispersion of 0.40. Inception of the BTB/Income composite was May of 1997.

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 9/30/02 was 33, which represents 87% of total assets managed in this strategy with a measure of dispersion of .22. Inception of the Distribution composite was December of 1998.

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 9/30/02 was 57, which represents 92% of total assets managed in this strategy with a measure of dispersion of 0.52. Miller/Howard Investments has prepared all performance results. Inception of the Alpha-Based composite was March of 1997. Some accounts were in a modified version of the strategy; they became part of the composite October 2001. Portfolio was managed by William T. Chidester from inception through November 2000. Team managed since December 2000.

...continued from page 5

to historic average absolute valuations, or valuations relative to the broader market, would generate returns in the 30% range. As we note in the Distribution report, repeal of the Public Utility Holding Company Act is very close, and repeal should create an abundance of M&A activity in the sector, reminding investors of the strong intrinsic values which reside there.

And how have utilities generally done after a period as vicious as the one just past? In 1974 there were two double-digit down quarters in a row, and the next three quarters gained nearly 40%. After 1987 the DJU gained about 8% plus dividends in the next year, and 28% plus dividends in the following two years. In 1994, when we sent out hats in June with the phrase "buying opportunity" imprinted on them (after a pair of double-digit down quarters), the DJU gained 14% plus dividends in the next year, commencing a string of six straight years in which our average annualized returns were typically in the high teens. We've had a bad run; the worst since the 1930's. We can't tell when a snap-back will occur, but we're more than in the zone right now. Our stocks are at attractive levels for private market buyers. The return on capital and return *of* capital to an "owner" is terrific right now. As earnings come in and scandals recede, these stocks will be found attractive by public market buyers as well. ❑

PO BOX 549 WOODSTOCK, NY 12498 / FON 845 679-9166 / FAX 845 679-5862 / WWW.MHINVEST.COM
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