Miller/Howard
INVESTMENTS, INC

MARKET OVERVIEW

It was a kind of financial Blob. You couldn't escape it. By the end of the quarter it was oozing in under the doorways, hurling in through open windows, reaching out from dashboard radios and grabbing morning commuters by the throat. It was on billboards in Times Square, and spilled from the lips of coffee drinkers in Starbucks. "New High! New High! New High!" The slime was everywhere.

We'd thought stocks had merely moved up to the high end of the ongoing trading range. But no. It was new high this, and new high that. The business reporters on TV were all but ready to pour buckets of champagne on each other.

So it set us to wondering, as we often do, about indices. Most of the public noise has been made about the very worst of these, the overly familiar and overly cited Dow Jones Industrial Average which, we're told touched a new all-time high. What's interesting at the moment is that while the index may have touched a new high, virtually none of its components did. Indeed, of the 30 Dow components, Dow observer Richard Russell notes that 21, or 71%, are at least 20% below their all-time highs. 17, or 57%, are at least 30% below their all-time highs.

Oh well, one says, that Dow is just a relic from the bad old days. Yet at the same time, when the S&P 500 (a capitalization-weighted index) hit a new high for the post-2003 rally, only 3 of 61 S&P industry groups made their own highs for the same time frame. Clearly, the indices, whether poorly designed or well made, don't really tell us all we want to know about equity performance. What they tell us is about themselves. They tell us the results of a process in which leading and lagging stocks are constantly changing places, until the point at which we choose to stop the music, measure, and say what the index has "done."

Here's the problem: how can we tell how equities are really performing? How can we tell if our strategy or our manager (gulp) is any good, or as good as we want? We don't think either the Dow technique—which just adds prices together and divides, giving thereby greater weight to higher-priced stocks—or the more professionally accepted capitalization weighting approaches really tell investors what they want to know.

Greater weight or influence in the index performance is given to larger stocks. As investors, though, aren't we seeking the best return at the lowest possible risk? Do we care whether the stock is large or small, or do we care about getting adequately compensated for the risk we are taking? Second, a capitalization-

THE STRATEGIES

INCOME-EQUITY STRATEGY

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

RISING DIVIDEND PLUS

A large-cap strategy comprised primarily of established and seasoned companies with high financial strength that are likely to provide steadily rising earnings and dividends.

BETTER THAN BONDS / UTILITIES

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

DISTRIBUTION / MERGING UTILITIES

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

TABLE OF CONTENTS

	PAGE
MARKET OVERVIEW	1
INCOME-EQUITY STRATEGY	4
RISING DIVIDEND PLUS	6
BETTER THAN BONDS/UTILITIES	8
DISTRIBUTION/MERGING UTILITIES	10

> *"Call us naïve, but we always thought the whole point of investing was to find stocks that had not yet moved up and had a reasonable chance of doing so."*

weighted index is actually a closet momentum strategy, since greater importance in the investment returns accrues to stocks that have been moving up in price (and thereby increasing their market cap). Call us naïve, but we always thought the whole point of investing was to find stocks *that had not yet moved up* and had a reasonable chance of doing so. However, if a cap-weighted index is the measure, then any manager's investment process is under pressure to distort and hold the stocks that happen to be moving the index at a particular point in time. If you respond that an investor's strategy should not adapt in that way, then you are saying that the whole notion of a "benchmark" index is not useful from an investment point of view.

That's not all. The S&P 500, for example, is not only cap-weighted (momentum-driven), it is also an actively managed group of stocks selected by a committee at Standard and Poor's who don't reveal the reasons for their selection of one stock versus another. Even so, rest assured that momentum is a factor. Do you recall which stocks entered the index during the tech bubble? It wasn't steel companies, that's for sure. It was the Amazons and AOLs of the world. What's been coming in the past couple of years? You guessed it: REITs, selling at record high valuations. In his 2004 paper, Jeremy J. Siegel of the Wharton School at the University of Pennsylvania concluded that the firms that had not been replaced in the S&P 500 outperformed the index with replacements: " the underperformance of the continually updated S&P Index is due to the overvaluation of newly admitted firms, which has been caused by the cyclical fluctuations in investor sentiment and price pressures exerted by indexers." The S&P is the worst offender in this, because there's a selection committee, but any cap-weighted index, including the various Russell or Wilshire indices, will suffer from the same bias.

Asking ourselves the obvious question—how can we avoid the distortions of index methodology and still have a measuring tool to gauge performance—brings us to the obvious answer: the appropriate measure of how the broad market or any group of stocks are doing (which is what comparison-minded investors want to know) is equal weighting with adjustment for risk. In this way a stock or strategy will be neither favored nor handicapped in the measurement process because it is large or small, volatile or slow-moving. What matters then in strategy or stock selection is whether or not it is "good." Whether or not it provides superior returns at a comparable level of risk.

Many analysts, hoping to organize stocks into neat groups by similarity, have taken further steps down the path more traveled by, and established style benchmarks for growth, value, midcap, smallcap, etc. which are also cap-weighted. But here the problems multiply. They especially multiply if you agree with an underlying premise, which is that *an investor or investment manager's process is to understand companies, industries, and sectors* in order to be able to discern value today and likely value tomorrow.

In 1986, just twenty years ago, 6 of the top 10 stocks in the growth index were energy companies. That means, of course, a portfolio manager would have to master the intricacies of energy exploration, supply and demand, OPEC, refining, financing—all the subjects that are relevant to the industry and the stocks within it. Today, those same stocks all dominate the value index. We're all in favor of managers learning and growing, of course, but weren't the "style" boxes proposed because different managers were alleged to have different styles? Doesn't that mean they would supposedly have heightened expertise in specific areas?

Today, for example, you will find among the most heavily weighted large-cap value stocks: energy, banks, drugs (former growth

SELECTED INDICES

	3rd Qtr'06	12 Mo
S&P 500	5.7	10.8
Equity Inc	5.4	11.5
Util Fund	6.3	8.8
R3UTIL	7.6	14.3
LB Long	6.4	2.5
LBGC	3.9	3.3
R1000	5.1	10.3
Valueline	0.8	4.1

S&P 500 = Standard & Poor's Index
Equity Inc = Avg Equity Income Fund (Lipper)
Util Fund = Avg Utility Fund (Morning Star)
LB Long = Lehman Long Government
LBGC = Lehman Bros. Gov/Credit Bonds
R3UTIL = Russell 3000 Utilities
R1000= Russell 1000
Valueline= Value Line Price Index

favorites), and, oops, Oracle. In large-cap growth Proctor and Gamble sits next to Microsoft, and Google is one rank up from Home Depot, and there are plenty of drugs and healthcare in this group as well. Perhaps the data that determines which stocks go in which "style" index is too old to be of use in our warp-speed world, but when we examine the specific stocks in both indexes it's clear that many issues are mis-categorized, at least in terms of how they've fared as companies in the past few years. How many investors interested in Value or Growth benchmarks have actually looked under the hood to see if these are at all meaningful to their investment objectives? Cap-weighting as a problem is intensified in the case of style indexes as well. Is General Electric almost seven times more important than Boeing? Maybe in the real world it is, maybe not. But if you measure your performance by a large-cap value index, it is writ in stone as of September 2006. There are tricks and traps around every corner. Are investors who "allocate" to both Mid-Cap Value and REITs aware that four of the top ten mid-cap value stocks are also REITs?

Space doesn't permit the duration of rant that we'd like to engage in on the subject of indexes and benchmarks and their flaws. Of course every attempt at creating order in an intrinsically chaotic arena is going to have flaws. But in truth, life can be much simpler and much clearer. From the standpoint of understanding all the potential risks and rewards of a particular investment, what links companies is not where they fall in an arbitrary cutoff based on balance sheet or earnings ratios. What links companies is the fact that they cope with similar challenges of supply and demand and technology and financing; in other words, what links companies is that they are members of the same industry group and/or sector. That's what enables an investor to make sound comparisons and determine which companies present worthwhile risk/reward profiles.

It's not about how big companies are, and it's not about where some system chooses to slot them in an index. It's about what they do, where they're going, how cheap they are relative to what value they might hold if they get where they're going, and what the risks are in getting there. A "benchmark" that held all stocks in equal weight, and adjusted each for its long- and short-term volatility would tell us how stocks have been performing, without distortions originating in size or style.

That's our beef at the moment, inspired by the fact that some indices have hit new highs while the majority of their components have not. ❑

"Are investors who 'allocate' to both Mid-Cap Value and REITs aware that four of the top ten mid-cap value stocks are also REITs?"

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

Annual ADV Update

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

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

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

"It's a sweet spot for our kind of stocks: a modestly growing economy, a world still awash in cash but starved for income, and a revitalized constituency for income-oriented stocks driven by a return to investment sanity after a couple of decades chasing moonbeams."

Quarter Composite

Income-Equity Net of Fee	5.1%
50/50 SP500 & Long Treas	6.1%
Russell 1000	5.1%

3-Year Composite

Income-Equity Net of Fee	13.9%
50/50 SP500 & Long Treas	8.8%
Russell 1000	12.8%

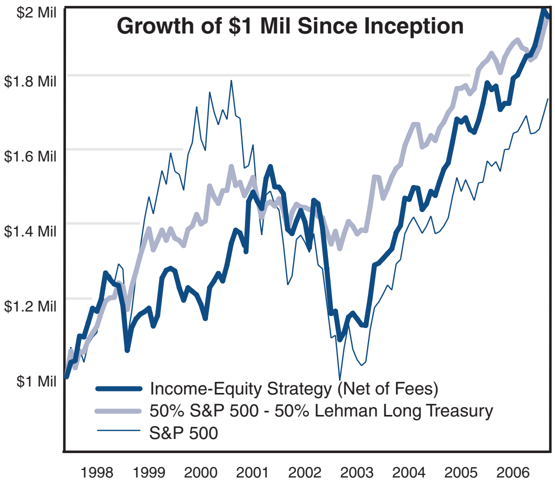
9-Year Composite Net of Fees*

Income-Equity*	6.7%
50/50 SP500 & Long Treas	7.1%
Russell 1000	5.8%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 9/30/06: 613 accounts in composite, representing 60% of total assets in the strategy with a dispersion of 0.22. Inception: 5/97. We offer a customized version of Income-Equity that excludes Master Limited Partnerships. These accounts are not included in the composite and represent 29% of the total assets in the strategy.

In the second quarter, we were pleased to see significant positive returns despite a downturn in the broad equity markets. This past quarter we were equally pleased to see our conservative group of stocks keep pace with the best third quarter for large-cap indices in ten years. In truth, we would be content with a large fraction of the equity upside and a smaller fraction of the downside (knowing that the net of this, in the long run, produces excess returns), so in the parlance of Wall Street, we've been beating our own expectations. It's a sweet spot for our kind of stocks: a modestly growing economy, a world still awash in cash but starved for income, and a revitalized constituency for income-oriented stocks driven by a return to investment sanity after a couple of decades chasing moonbeams. This environment is driven as well by an historically unique demographic in which both individual and institutional investors want growth, stability, and income all in one package. With all humility we must acknowledge: we are that package.

Some satisfying news: for many years analysts have questioned our inclusion of a mixed benchmark (50% S&P 500, 50% Long Treasuries) as one way to analyze what we do, since what we do is somewhat (and inexplicably, to us) unique. There are two arguments proposed against this benchmark. First, in hindsight it is not the most highly correlated item you can find in the universe of comparisons. Second, it is "mixed," neither all equity nor all fixed income, and our strategy is all equity. But, we say, but, but, but. What other strategy has a *yield* element that is similar to fixed income? (In fact, ours is superior, short and long term.) How do you account for the high-yield element, which any market historian knows is at least as important in generating long-term total returns as capital appreciation? How do you compare a greater-than 5% income instrument with reduced volatility to less-than 2% income instrument with "market" volatility?



It is like trying to compare IBM to the Internet index.

Interestingly, portfolio holding Enterprise Products issued a 50-year debt instrument this quarter, coming much closer to the duration of an equity (which is, theoretically, infinite), and easily twice as long in duration as nearly all credit paper in the market. For purposes of evaluating the impact of this debt on EPD's balance sheet and credit rating, both S&P and Moody's determined that it should be considered—due to its duration and its volatility—as 50% debt and 50% equity. Hallelujah! To paraphrase Rilke, we see debt considered as equity to be "the other side of the same thin coin." We're not so dumb after all!

PORTFOLIO HIGHLIGHTS

When we first bought Proctor and Gamble, we decided that although it was on the low end of our dividend yield range, the company, selling in the low quintile of its historic valuation, had a lot going for it. First, it would likely be a participant in a revival of interest in large-cap stocks, which we felt would occur later if not sooner. Second, it would benefit from a movement of substantial duration toward defensive and consumer non-durable stocks (and we thought that low long-term bond yields were suggesting this).Third, the company had

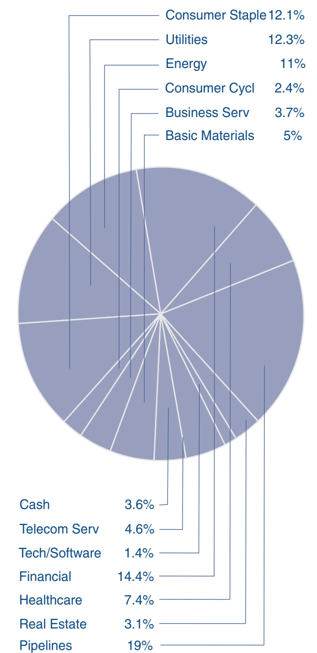
made a transformational acquisition of Gillette, one that would enable higher growth rates as it transitioned, and one that the market was certainly not paying up for at the time. Fourth, a bit more abstractly, great global consumer brand companies are every bit as much a play on emerging markets and the growth of global consumers as are energy or copper, and consumer products companies have a chance to be more than just commodities. Finally, it was a classic persistent-growth-dividend-growth company selling at an unusually low valuation—just the kind of stock we seek to buy. One quarter doesn't make a case, but it appears to us that the Gillette acquisition is now complete (and successful); each of our other points in the stock's favor are in the early innings.

In addition to PG, stocks that added to performance through double-digit gains were an interesting assortment from a variety of sectors. Microsoft rose in a strengthening technology sector, in part we think as investors positioned for the release of MSFT's new Vista operating system, which should drive revenues for many years. A $3.8 billion repurchase of stock surely didn't hurt. ONEOK and ONEOK Partners both pulled strong oars, on upward guidance for the year. Abbott Labs offered an earnings surprise and upside guidance, and a promising report on the drug-eluting stent technology the company acquired as a participant in Boston Scientific's acquisition of Guidant. United Utilities rose nearly 12% as merger fever struck British water utilities. Bayer reported an upside earnings surprise and came close to completing its deal for Schering AG.

Portolio managers never get credit for what happens after a sale, but we'd like to take some this quarter, since our sales added a lot of value to our returns. Tenaris rose much more quickly than we expected, including a large bi-annual dividend. We made a quick exit from what we have called an "opportunistic move" with a 20% return. The stock has lost 12% since then. NTE announced that they were changing their dividend policy to allow for more capital investment, a red flag to us and a violation of our portfolio rules, so we sold immediately for a slight loss. A few weeks later the company reported disappointing earnings, and the stock lost another 40% of its value. We sold Bristol Myers when it became clear that their deal to keep Plavix from generic competition would not work and might provoke a scandal. The stock immediately dropped 20% subsequent to our sale (though it later rallied on investor thoughts of a buyout and a temporary court victory coming on the heels of stock price snapback). We replaced it with Pfizer, which rose about 8%. We'd held BP as a "best in class" international oil company, one of the few that could pass our social responsibility evaluation. But it turns out that BP has come up short on the maintenance side of their business, and it seems as though all the lightbulbs are burning out at once. We sold the stock for a 60% long-term gain (since initial purchase in the portfolio) and did not replace it with another energy related company—the stock is off about 10% since then. These kinds of often overlooked changes are just as important as "picking winners" for long-term performance.

LOOKING FORWARD

Our current "stated" yield is just over 5% but that understates the true cash yield from income for the portfolio this year. That yield never really captures the effect of special dividends. Importantly, Alberto-Culver plans to split up shortly, with holders receiving shares in its two main business units plus a roughly 50% distribution in cash. This raises our annual yield closer to 6.5%, even for new accounts—if opened before the ACV transaction occurs, currently expected to be at the end of November. ❑

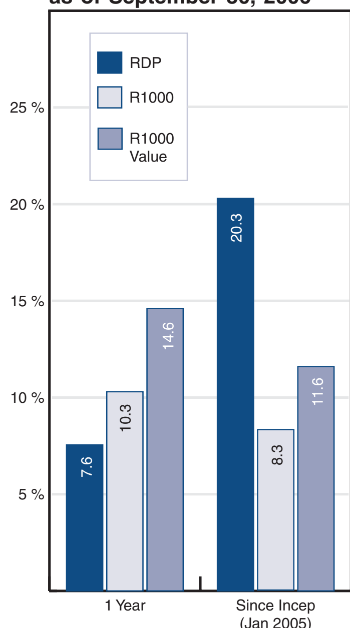


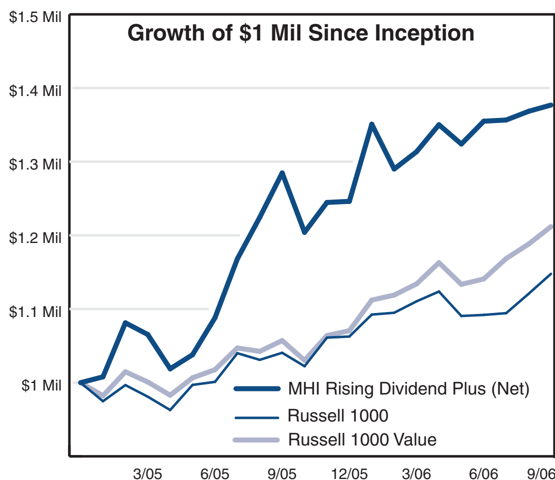
FUNDAMENTAL CHARACTERISTICS

Yield	5.2%
Proj Dividend Growth	8.0%
Payout Ratio	57%
Market Cap	$39.1 Bil
Price/Book	2.8
P/E Ratio	14.3
S&P Rating	BBB+
Beta*	.5
R-Squared*	.5
Standard Deviation	11.4

Relative to S&P 500, 9/30/99 - 9/30/06

For those who missed our introduction of Rising Dividend Plus last quarter, this strategy uses dividend growth–perhaps the most unequivocally accepted positive factor associated with excess performance among substantial and seasoned companies–as a primary focus. It differs from our Income-Equity Strategy, in which dividend growth is also important, by placing less emphasis on current yield. We also utilize certain anomalies which have been alpha drivers since inception of the strategy in December of 2004. All the good dividend-paying companies that can't make it into Income-Equity because their yields are too low can find a home in Rising Dividend Plus.





YTD Composite

Rising Dividend Plus Net	10.9%
Russell 1000	7.9%
Russell 1000 Value	13.2%

Cumulative Since Inception (Jan 2005 - Sep 2006)

Rising Dividend Plus Net	38.2%
Russell 1000	14.7%
Russell 1000 Value	21.2%

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 9/30/06: 2 accounts representing 98% of assets in the strategy, with a dispersion of 0.04. Inception: 12/04.

PORTFOLIO HIGHLIGHTS

We had a positive quarter, though performance relative to other strategies was far from our best. Indeed, the only notable benchmark we bested was the equal-weighted Value Line Index. While an overweight in the energy sector helped our performance mightily in 2005, and didn't hurt in the first half of 2006 despite poor energy sector returns, this group dampened our performance for the quarter. The rest of the portfolio had to work hard to overcome double-digit (or nearly so) declines from Anadarko, Pioneer Natural Resources, Halliburton, etc. Faltering product prices were obviously behind the corrections, but at this point we have no thought to exit these positions, since we see this moment as an anomalous weather-induced pause in a larger trend that can only be considered epochal. We didn't replace our two gas stock takeovers from last quarter with new energy positions, but at some point we very well might.

Our heavy weights did some heavy lifting as compensation. The analyst community clearly got it wrong with Allstate, who beat earnings estimates by $.39 (over 20% better than expectations), and raised guidance for both earnings and revenues for the remainder of the year. As we write, the 2006 hurricane season is winding down without a major storm, so the company looks good to go on guidance. We're not really quarter-to-quarter people, but it's hard not to get excited at such a large (and clean) gap between expectations and performance. If the market is at all efficient, over time the stock price will inevitably catch up. Even as the market was writing off the investment banking group, after a major run earlier in the year and in 2005, Goldman Sachs joined Allstate in almost as large an upside earnings surprise; the stock responded with a 13% gain for the quarter. We have long thought that investors were being far too fussy about management changeover and threatened legal problems at American International Group, which is the world's largest insurance company, and the fastest growing pound for pound (yen for yen?) as well. There has been typical volatility at bottoms for a while, but we believe the company is on the threshold of returning to its former status trading at a large premium to the great gray undifferentiated multi-line insurance group. Here too the company reported a nearly 20% upside earnings surprise (what's happening with these finance sector analysts?), continuing a pattern in the portfolio. The stock was up 12% for the quarter. We've never said stock

picking was anything other than excruciatingly difficult, fraught with known and unknown risks, but we might make an exception in this case.

Elsewhere, we were helped by UnitedHealth (another large-cap turnaround, like AIG, that really doesn't have much if anything wrong with it), and packaging company Ball Corp (another upside earnings surprise). Johnson & Johnson and General Electric led a kind of Revenge of the Large Caps in the market this quarter, a trend that we think is quite likely to continue.

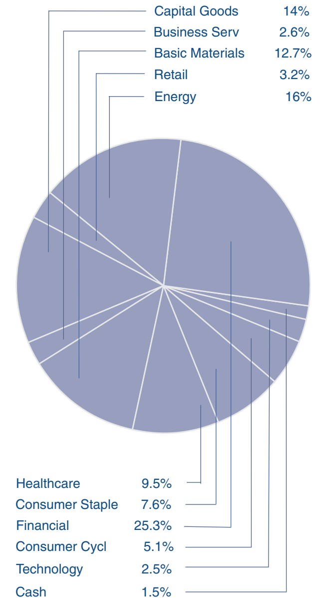
We sold our two takeover stocks from the third quarter (Kerr-McGee and Western Gas), lightened up American Express and Citicorp (that was back in prehistory, when it appeared as though the Fed might be raising rates some more), took profits in Chicago Bridge and losses in Analog Devices (business turns out to be far from what had been thought) and Medtronic on rather poor guidance from the company indicating prospects that were slack at best. These mediocre reports would not always prompt us to depart a position, but we found better opportunities awaiting.

Scott's Miracle-Gro turned up on our screens after a nearly 25% correction from it's 2006 high, complete with raging volume as the shares were transferred from weak to strong holders. We bought at roughly the price you'd pay for a utility, for this company which *is* a kind of a utility, the utility of plant food, far dominating its category, dominating to such an extent that seemingly every plant in Home Depot or Lowe's nursery department carries a bright and happy "Miracle-Gro" mini-billboard sticking up out of each pot. And you should see our pumpkins!

We've been excited about the prospects for mutual-fund oriented asset managers since the passage of pension reform recently in Congress. Basically the world is now moving even faster to 401(k) plans from traditional plans—which means much more business for mutual fund companies. In addition, there are new rules permitting plan sponsors to automatically enroll employees (opt-out instead of opt-in) in their 401(k)'s. This is really big news for asset managers and custodians, with some experts suggesting a 60% increase in assets over 5 years, above and beyond what would have happened anyway and without taking into account any market appreciation (or depreciation, we assume). Legg Mason has been foundering at the bottom of the asset-manager valuation pile, as investors shied away from the stock during its transition period (LM has acquired all of the Citigroup Asset Management funds). We bought after a disappointing earnings report drove the stock still lower during a general downtrend, yet the company increased its dividend—which we took as a signal of the board's view about future prospects. Here we're looking across the valley; mutual fund managers have gotten a turbo-charger from Congress, the combination of the two companies will create a mutual fund enterprise competitive in size to Vanguard or Fidelity in the 401(k) market, and it seems to us that with even modestly competent execution LM can prosper in the environment ahead. A normalized PE on normalized earnings gets us a very substantial stock price appreciation here, and we're 6% ahead since a September purchase, early in the story.

LOOKING FORWARD

We like the stocks in our portfolio now, and find no urgency to replace either stocks that are down or stocks that are up. Indeed, we look to the long term for all of these, though we may take note of an earnings report from time to time as a gauge of the future. We do think energy stocks may have a resurgence, and we will be ready to participate opportunistically if the elements we require should make an appearance. ❑



FUNDAMENTAL CHARACTERISTICS

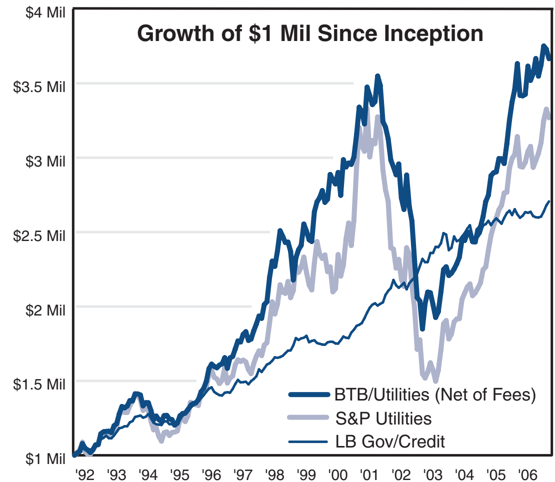
Yield	1.5%
Proj Dividend Growth	10.1%
Payout Ratio	25%
Market Cap	$56.7Bil
Price/Book	3.0
P/E Ratio	16.9
S&P Rating	A-
Beta	NA*
R-Squared	NA*
Standard Deviation	NA*

*NA - Not Applicable. Not enough data points.

"Natural gas has definitely hit a soft patch on pricing, but the basic fundamental case—that less gas is being found and produced even as more is being used—remains undented, in our view."

We had another positive quarter, though our exposure to gas producers dragged down returns substantially for the period, taking back some of what they gave us last year. But we've never believed our positions were trading ideas which would warrant in and out activity, and we still don't. Natural gas has definitely hit a soft patch on pricing, but the basic fundamental case—that less gas is being found and produced even as more is being used—remains undented, in our view. A record warm winter followed by a moderate summer season (gas is now used for cooling, too, as a fuel for electricity production) has resulted in abnormal inventories and low prices—both of which features we believe will prove transient and temporary.

Not only did gas stocks provide a damper this quarter, but our returns look extraordinarily tepid compared to the Russell 3000 Utilities. We've worked hard to find an appropriate "benchmark" for a portfolio that is really like no other. We've managed to blunt the effect of large-cap nuclear electrics which dominate the Dow Jones Utilities Average and S&P Utilities and which we don't own by policy, but this quarter and year makes the whole benchmarking enterprise seem a bit hopeless. It turns out that 18% of the weight in the capitalization-weighted R3000UT is accounted for by AT&T and BellSouth. Since the latter is being acquired by AT&T in a stock deal which causes BLS stock to move in tandem with AT&T, as a practical matter 18% of the index is in one stock. Add another 10% for Verizon, and you have 28% of the index weight in 2 stocks. (T was up 18% for the quarter, BLS up 19%, and VZ up 12%). Since as a matter of prudence and diversification we almost never hold a position greater than 5% in any one stock (and even that high a weight is unusual), there



is no way we could look anything like that benchmark for this quarter and year. This powerful move in these former RBOCs was probably something like a Katrina of the telecommunications sector in its rarity, and that is perhaps the best news in the situation for comparison-makers: it's unlikely to happen again anytime soon. To that we would add the caveat that it was also unlikely to happen the first time, and the further caveat/admission that we certainly weren't complaining when the shoe was on the other foot last year. Still, from a long-term perspective we'd rather keep our shoes right where they are.

PORTFOLIO HIGHLIGHTS

Our foreign telecom stocks were significant winners this quarter, though their weight was nowhere near that of the former RBOC bullies. Vimpel Communications delivered strong earnings and continued to be the subject of takeover speculation—we took partial profits near the peak of its 35% runup. China Telecom continues to be one of our standout performers, rising 23% for the quarter and more than doubling since our first purchase in December of 2004. Telfonos de Mexico added about 20%,

Quarter Composite	
BTB/Util Net of Fees	1.5%
Russell 3000 Utilities	7.6%
S&P Utilities	6.1%
LBGC	3.9%
3-Year Composite	
BTB/Util Net of Fees	17.8%
Russell 3000 Utilities	17.6%
S&P Utilities	20.2%
LBGC	3.1%
10-Year Composite	
BTB/Util Net of Fees	8.3%
Russell 3000 Utilities	5.1%
S&P Utilities	7.9%
LBGC	6.5%

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 9/30/06: 165 accounts representing 95% of assets in the strategy, with a dispersion of 0.19. Inception: 9/91.

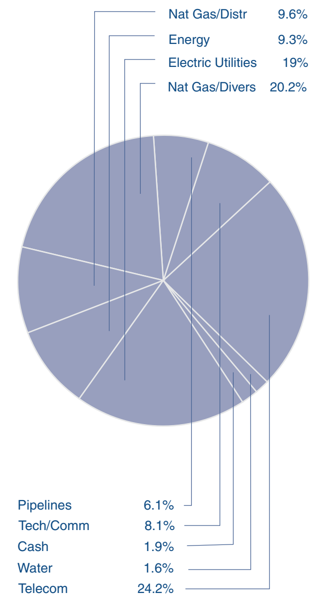
as the excruciatingly slow resolution of the Mexican elections was finally resolved. We also added Mexican cellular company America Movil, a company whose broad exposure across Latin America gives it far greater growth opportunities than North American operators. PT Telekomunkikiasi Indonesia continued higher as well. We added a small position in Qualcomm after it declined sharply. In addition to Nokia, the company is the single biggest supplier beneficiary of the "wirelessing" of the world, but it sells at a valuation comparable to a growth utility.

We did hold "normal" positions in AT&T and Verizon, and both helped returns. Our traditional utilities contributed as well, with companies like ONEOK, Northeast Utilities, United Utilities, WGL Holdings, and Sierra Pacific all adding to performance. SRP in particular appears to have all the elements of its turnaround in place, with legal victories, debt paydown, and congenial regulation all arguing for higher valuations in the future. We also anticipate the renewal of a dividend in the upcoming quarters, which would no doubt draw an additional constituency to the company.

We took profits in Peoples Energy after WPS announced a takeover offer which we thought would not be topped. Likewise, we sold IdaCorp as fully valued, after the company sold its IdaTech fuel cell subsidiary, which we'd seen as a possible hidden story in the stock. We exited Telstra with a neutral result, electing to watch on the sidelines as the company attempted to resolve escalating disputes with the government, majority owner of the firm. Part of the cash from these sales was used to increase our weighting in Southern Union, whose move from local distribution utilities to pipeline and midstream operations seems sound to us and likely to increase their valuation. We also increased our weight in Sprint, the laggard in the telecom space and a significant drag on our performance for the quarter. They provided a downbeat report and guidance, but we thought the news was more than reflected in the stock price, and we see the company as a decent acquisition candidate, the last one left, really, for any foreign acquirer who wants to enter the US market. Too, Sprint has a considerable asset in spectrum needed for WIMAX implementation—a wild card at this point but a potentially potent future entrant in wireless broadband.

LOOKING FORWARD

As we've noted in previous quarters, conditions remain attractive for this portfolio. In a softening economy investors are drawn to the repeating business models of the companies we hold, and the services they provide offer the most inelastic demand profile in the economy. Our more traditional utilities should continue to benefit as they have for the past few years from the quest for income and stability. Should economic growth heat up, our gas-related stocks as well as the foreign telecoms are likely to do well. Underlying corporate growth has been good in our stocks with few exceptions, and valuations remain reasonable. We have no plans to put nearly a third of the portfolio in two stocks, however. ❑

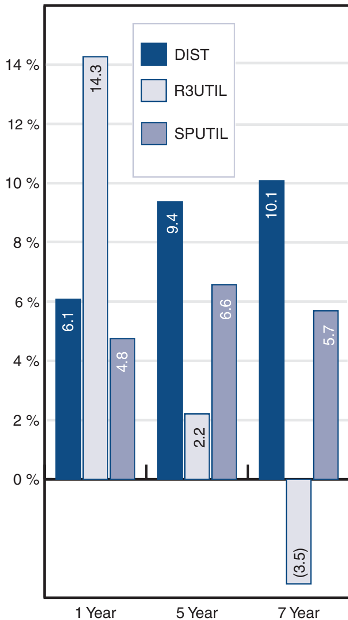


FUNDAMENTAL CHARACTERISTICS

Yield	2.6%
Proj Dividend Growth	6.4%
Payout Ratio	39%
Market Cap	$25.2 Bil
Price/Book	2.8
P/E Ratio	17.0
S&P Rating	BBB+
Beta*	0.6
R-Squared*	0.4
Standard Deviation	14.6

**Relative to S&P500, 9/30/99- 9/30/06*

Annualized Net of Fee Returns as of September 30, 2006



Quarter Composite

Distribution Net of Fees	6.3%
Russell 3000 Utilities	7.6%
S&P Utilities	6.1%
S&P 500	5.7%

3-Year Composite

Distribution Net of Fees	16.8%
Russell 3000 Utilities	17.6%
S&P Utilities	20.2%
S&P 500	12.3%

7-Year Composite

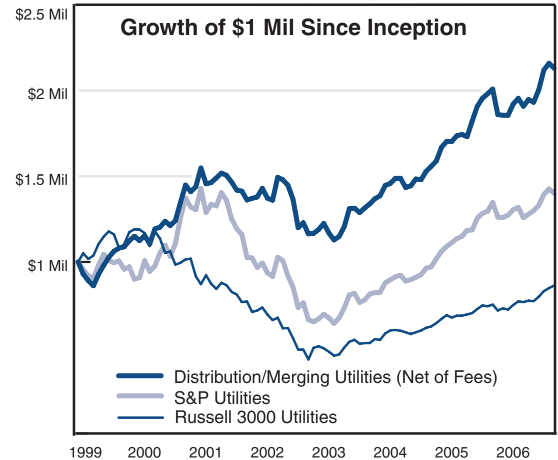
Distribution Net of Fees	10.1%
Russell 3000 Utilities	(3.5)%
S&P Utilities	5.7%
S&P 500	2.2%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 9/30/06: 220 accounts, representing 95% of total assets managed in the strategy with a dispersion of 0.15. Inception: 1/99.

Last quarter we noted that the Distribution/Merging Utilities strategy had shown itself capable of delivering solid positive returns without any correlation to either equity or credit markets. This quarter we saw fine performance that was, in fact, correlated to rallies in both the equity and the credit markets. While we won't suggest that this have-your-cake-and-eat-it-too condition will last indefinitely, the news has been good. Our stock valuations do not inspire vertiginous thoughts, and it seems a different set of companies provides leadership nearly every quarter.

M&A activity has been ramping up among our companies and among utilities globally, though many of the transactions are at the asset level rather than for the total enterprise. We did have one more takeover in the portfolio this quarter; Peoples Energy (PGL) agreed to be acquired by WPS for a small premium, all in stock. We sold soon after the announcement, perceiving further upside to be limited, but it's good to see a persistent level of consolidation activity.

Of some concern, outside of our portfolio, was the announcement that Exelon and Public Service Enterprise Group terminated Exelon's planned takeover due to irresolvable problems with New Jersey regulators, primarily centering on market power and customer rate issues. Too, similar problems have arisen with Maryland regulators regarding the proposed merger of Constellation Energy (formerly Baltimore G&E) with FPL. Despite repeal of the Public Utility Holding Company Act there are still impediments—in the form of state regulatory power—to large mergers between geographically remote companies. This is an issue that varies state-to-state in its complexion and one which may limit certain kinds of merger activity, and it's unlikely to go away. However, our portfolio is focused on mid-cap and smaller



names primarily, and we cannot think of a single deal for a smaller name, whether by a larger or similar-sized company, which has been rejected by regulators. Too, these two situations may be slightly unique: even as we write there are rumors of a deal between Southern and our holding Progress Energy—in an area where the local regulatory climate is unlikely to prove resistant. Regulatory character has always been a key ingredient in our analysis for this portfolio, and the two deals noted above show precisely why it is so important.

PORTFOLIO HIGHLIGHTS

On a global level the march of utility consolidation continues unabated. E.On recently *raised* its existing offer for Spain's Endesa by 38% due to new competition. If they win, to fund that offer they'll need to sell Endesa's Latin American operations—creating a second transaction frenzy across the sea. An investor group is on the verge of acquiring British water utility AWG. This worldwide trend no doubt accounts for the excellent performance of our new addition Russian cellular provider Vimpel Communications, which was up some 34%. Its two largest shareholders both want to own the

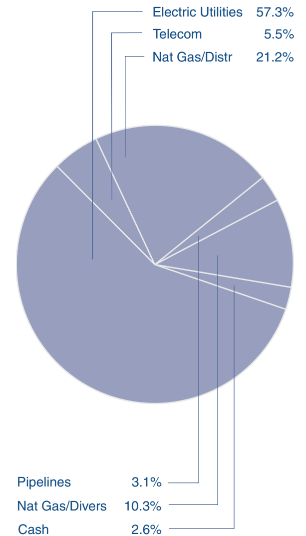
whole company. Meanwhile growth has been extremely strong, driven by expansion into the "stans" of the former USSR. We also had 13 double-digit performers, mainly among our traditional plain vanilla holdings.

Nstar turned in a frankly surprising gain of just under 20%, as the company announced increased long-term earnings growth guidance of 6-8%, based on a newly-implemented 7-year rate agreement. This one is nearing full value, but it is also a prime candidate for National Grid's continued expansion into the Northeast. Centerpoint rose about 15% on the heels of a major rate settlement and the company appears poised for substantial gains in the years ahead as a recovery stock. CMS rose about 12% after the company agreed to sell its interests in the Midland Cogeneration plant to a private equity group. Dynegy, up about 4%, made a major acquisition, buying 8300 megawatts of generating capacity from LS Power Group for some $4 billion. We'd hoped DYN would be an acquiree rather than an acquirer, but stay tuned. Mirant, recently frustrated in its hopeless offer for NRG, is still hungry, and there are many other would-be diners. Northeast Utilities, up 14%, completed its exit from the wholesale/merchant side of the business, selling 15 generating plants to a private equity group (is there a pattern here?). Now that NU is a nearly pure distribution company, there are a variety of nearby companies that may be considering a marriage proposal. Southern Union, which had a slightly down quarter but which has done well this year, is also busy in the asset-transaction world. The company will sell its Transwestern Pipeline Co to Energy Transfer Partners (a company from our Income-Equity portfolio), and, in a complicated series of transactions, will wind up as a 50% owner of Florida Gas Transmission, along with El Paso Corp, a new addition to the portfolio. You definitely need a scorecard, as assets rotate around the industry while the players create their strategic territories.

We reduced our weighting in Southwest Gas and Alliant Energy, viewing recent prices as leaving only modest room for a premium in a transaction, though both remain attractive from a strategic standpoint. We sold Western Gas early in the quarter, since it agreed to be acquired by Anadarko. We sold IdaCorp to make room for new ideas, since the company has exited its very interesting fuel cell subsidiary and doesn't really have great transaction appeal, in our view, in the absence of that hidden potential. We added Edison International with an eye toward a potential sale of its merchant power subsidiary (there's no lack of buyers for plants, now that the national generating surplus is fading), El Paso—which could be acquired for its pipelines, its gas reserves, or both, and a few other small positions which we'll discuss another time, when space permits.

LOOKING FORWARD

Increased asset and corporate transaction activity in the utility industries, a pause in interest rate increases, and investors' increasing taste for defensive stocks with yield—all argue for a continuation of positive returns, if perhaps at a more modest rate than we've seen so far this year. Some stocks reflect a little more enthusiasm than we'd like, and we anticipate trimming and replacing in these cases, as we did this past quarter. Otherwise, little has changed and utilities continue to provide the single most necessary products in the world—as all of us on the East Coast learned very well during the blackout of 2003. ❑



FUNDAMENTAL CHARACTERISTICS

Yield	3.1%
Proj Dividend Growth	4.5%
Payout Ratio	49%
Market Cap	$6.9 Bil
Price/Book	1.9
P/E Ratio	16.9
S&P Rating	BBB+
R-Squared*	0.2
Beta*	0.4
Standard Deviation	12.8

**Relative to S&P 500, 9/30/99 - 9/30/06*

"Compounding interest is the greatest mathematical discovery of all time."
- attributed to Albert Einstein

"Compounding is the money that money makes, added to the money that money has already made. And each time money makes money, it becomes capable of making even more money than it could before! This is called a *virtuous circle*, and it's what we want to get working for us."
- Lowell Miller
The Single Best Investment (Print Project)

MILLER/HOWARD INVESTMENTS DIVIDEND-GROWTH STRATEGIES

PORTFOLIO	FOCUS	YIELD	EST. GROWTH OF YIELD	7-YEAR BETA	P/E	YEAR TO DATE NET OF FEES RETURN
Income-Equity Strategy	High current income + dividend growth, broad market	5.2%	8.0%	0.5	14.3	14.5%
Rising Dividend Plus	High financial strength companies steadily raising earnings and dividends	1.5%	10.1%	NA	16.9	10.9%
Better Than Bonds/Utilities	Utilities sector: natural gas, electric, telecom, and water	2.6%	6.4%	0.6	17.0	7.4%
Distribution/Merging Utilities	Local distribution utilities, takeover candidates	3.1%	4.5%	0.4	16.9	14.9%

as of September 30, 2006

Miller/Howard
INVESTMENTS, INC
PO Box 549
Woodstock, NY 12498

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