

**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 portfolio of large- and mid-cap companies in which dividend growth is the key variable, focusing on companies with proven long-term success or special current opportunities.

**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.

**W**hile the shorter-term overall market environment both here and abroad may be subject to fits and starts as many stocks are overbought as we write, and ripe for some profit-taking, longer-term investors should be heartened by the events of the last three months.

In the past five years our world, our economy, and our markets have taken a licking and kept on ticking, as they used to say about a durable and inexpensive brand of watches. We've mentioned this before: a tech bubble up and tech bubble down, terrorism and 9/11, wars in Afghanistan and Iraq; short-term interest rates down to 1% to stave off deflation, followed by relentless increases back to 5.25%; a plummeting dollar; outsourcing and further job loss in the manufacturing sector; a desperately unpopular presidency; nearly unprecedented collapse in the housing market; and finally, this summer, total dysfunction and freeze-up in the credit markets. Problems with the vast and unregulated market of derivatives are always thinkable—and the derivatives/leveraged activity around sub-primes could not have been totally unexpected. But the spread of tension that led to banks refusing collateral and overnight loans of almost any kind was astonishing, and stocks rightly collapsed during the summer.

But the Federal Reserve—and now that term seems to encompass many of the mature economic nations, we might almost call it the Global Federal Reserve—rode to the rescue with liquidity provision and interest rate reduction, just as it had after 9/11 and during the deflation scare of 2003. Success in containment seems once again assured, and brings to mind again the notion of a “Greenspan Put,” revised more generically as a “Fed Put,” in which the national treasuries and banks trade asset inflation for incipient economic malaise.

Even so, we would have thought investors, having lived for some years under the shadow of the OTC derivatives market, would have been a little more gunshy about jumping back into the market after such unique and significant turmoil in the credit markets. What explains this avarice for stocks? Back in the bubble we coined the phrase “too many derrieres and not enough chairs,” and it seems apt again. Not that we think stocks are too high and won't go higher in both the intermediate and long terms. It's just that the rally, in the face of unusual uncertainties, smacks of a young herd just bursting in its pen, ready to run when the gate opens. When other, more worried investors, opened the gate by selling in huge volume over the summer, this young herd nearly jumped the fence to take the places others had vacated.

We can't prove this, of course, but we can point out that the U.S. debt and equity markets are valued at roughly \$50 trillion, with the equity market at \$15 trillion, according to the International Monetary Fund. To give some sense of scale, the assets of global High Net Worth investors, according to Capgemini, grew by \$33 trillion last year, or twice the value of the U.S. stock market. There are about \$12 trillion in the U.S. public and private pension plans, and about \$8 trillion in M3, containing readily available cash and large CDs. Public corporations hold \$2 trillion in cash, by most estimates, and no one has yet to hazard a guess

<b>TABLE OF CONTENTS</b>	<b>PAGE</b>
MARKET OVERVIEW	1
INCOME-EQUITY STRATEGY	4
RISING DIVIDEND PLUS	6
BETTER THAN BONDS/UTILITIES	8
DISTRIBUTION/MERGING UTILITIES	10

*“But, as we write, in the absence of a crystal ball we can’t see any other conclusion and strength is certainly the odds-on wager.”*

about the cash assets held by private companies and investment real estate owners. Sovereign investment funds, intended to diversify the reserves of various countries, are growing fast and will reach \$10 trillion by 2012. Again according to the IMF, U.S. investors hold only about 1/3 of the total value of global bonds and equities, meaning that there’s more than \$100 trillion in non-domestic assets available for shuffling into our markets, in addition to the \$32 trillion of earmarked investment funds noted above and countless trillions owned by high net worth individuals, by princes, by kings, by generals, by shadowy dealers of things below the radar. All those trillions, taking aim at our poor little well-regulated and secure \$15 trillion comparative pittance of a market. And that’s before you add in leverage. No wonder equities always bounce back!

Every so often we review a set of key market factors. Our strategies don’t involve timing the market, but everyone involved in investing wants to get a handle on the nature of the environment, including ourselves:

- 1) *The Fed* tried to stay away from the fracas of the markets, but the subprime meltdown and collateral damage forced it back to the microphone, and it seems the Global Fed has done a good job in quieting the crisis and returning the economic daily round to something like normalcy. Since expectations and confidence among investors are key to smoothly functioning markets, the role of an assertive and effective Fed can hardly be overestimated. Future moves will be as always “data dependent,” but weighing various domestic weaknesses, dollar weakness, and global economic strength, our view is that the Fed will do everything possible to avoid another rate cut.
- 2) *The dollar*, already undervalued in terms of purchasing power parity, has been sacrificed enough. To be sure it is a help to our manufacturing economy, but not to the attractiveness of our debt or equity to foreign investors, and at some point there is risk of a vicious spiral in which foreign

money seeks higher interest rates, abandoning and weakening the dollar to a point where it triggers aggressive inflation, further weakening the currency, etc.

- 3) *Global geopolitics* has quieted down over the past few quarters, save the ongoing chaos in Iraq, saber-rattling with Iran that is unlikely to go anywhere without European assent, assent that’s far from forthcoming at the moment. In the absence of an event domestically, it’s not an issue for the market. And it’s early yet for presidential politics to have much effect.
- 4) *Valuations* are selectively okay, and on average okay. Given that oil is likely in our view to retrace some of its earlier run, energy stocks seem generally fully valued to us. Many consumer nondurables are at prices non-sustainable, unless we are in a world reverting to the nineties and its consumer nondurable valuations, which we doubt. However, companies with ample foreign business, like Colgate and Procter and Gamble, should benefit from the global increase in the consumer class. Financials are cheap enough, especially in a low-interest-rate-but-positive-spread-environment.
- 5) *Traditional sentiment indicators* are reasonably bullish, though not so much as they were during and after the high-volume selling climax in August. Most measures are on the bullish side of neutral, though not extreme. This is to be expected, as rising prices seduce more skeptics, but we’ll watch the number of bearish newsletter writers and market strategists when some profit taking sets in—a moment we think is not far off. If the bear numbers rise quickly, it will be time to polish up your shopping lists.
- 6) *Our proprietary options indicator* remains bullish, as it did through the summer. This measure of committed index option put and call holdings reveals fear on balance among investors and speculators who have actually put money down on the table. It was positive if not especially so at the end of last quarter, suggesting that

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#### SELECTED INDICES

	3 <sup>rd</sup> Qtr07	12 Mo
<b>S&amp;P 500</b>	2.0%	16.4%
<b>Equity Inc</b>	0.1	15.5
<b>Util Fund</b>	3.6	28.1
<b>R3UTIL</b>	0.4	20.6
<b>Long Bond</b>	4.9	4.4
<b>R1000</b>	2.0	16.8

S&P 500 = Standard & Poor’s Index  
 Equity Inc = Avg Equity Income Fund (Lipper)  
 Util Fund = Avg Utility Fund (Morning Star)  
 LB Long = Morningstar  
 R3UTIL = Russell 3000 Utilities  
 R1000 = Russell 1000

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declines would be mild. Of course an indicator like this is no predictor of credit market meltdowns, but in our view considering the severity of the financial event, the actual decline in the major indices (there were of course more extreme individual stocks) actually wasn't very steep, barely touching 10% and then only for a minute. This indicator has come off its best readings as well, but remains supportive, suggesting mild declines as a worst case but more probably further market gains.

- 7) *Chart technicals*, on the other hand, strongly suggest an intervening correction. The huge volume of August was a technical green light for a reversal, and strength in general has been suggested since February by the inexplicably persistent volume at a higher sustained level than ever before seen. Maybe it's just the wait for key data, but trading volume declined after the climax, which is okay, but it did not return as prices began to rise again, which is not okay. By every measure we look at a bull market remains intact, but it is a little short-term overbought as of this writing and there is no volume growth to support that minor excess. We'd expect to see a test, not of prior lows but of investor fortitude, before much further progress unfolds.
- 8) *Insiders* got busy soon after the lows, and the readings are bullish at a level that hasn't been seen in several years. Of course not every company has seen insider buying, and not every insider has a better clue about the right price for his stock than you and we, but on balance insiders have a rather good predictive record in a time frame of greater than six months.
- 9) *Hidden taxes* abound, as energy and food prices remain higher than ever. Too, the housing decline is a kind of hidden tax or a damper on growth, for it truly reduces the amount of money in circulation as well as numbing the brain's avarice nodes, which apply to shopping and dining out as much as to condos. There are plenty of drags on

growth about, but that's good news for investors in our kinds of stocks. Interest rates will remain low. And the global economic boom, to the extent that it affects our economy, won't be producing bubbles locally.

- 10) *The economy* just keeps going, no matter what gets tossed under its wheels. All it seems to need is a little fed-oil from time to time. We're impressed, and until proven otherwise we need to bet with the trend, daily dose of Cassandras in the media notwithstanding. Growth with low interest rates and minimal inflation still appears intact. They used to call this Goldilocks. Perhaps that's too cheery a phrase when mortgages are going into foreclosure by the hundreds of thousands. But, as we write, in the absence of a crystal ball we can't see any other conclusion and strength is certainly the odds-on wager.

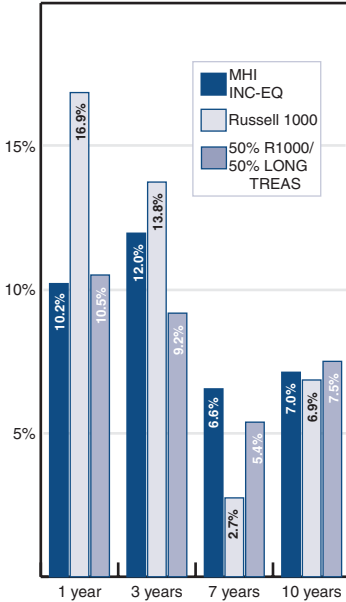
*"The economy just keeps going, no matter what gets tossed under its wheels...We're impressed, and until proven otherwise we need to bet with the trend."*

We hope and believe that the subprime mess, as it's called, will bring out the healing. Regulation to regulate market participants who clearly can't control themselves is probably needed and will probably be forthcoming. More than that, however, we hope the derivatives market has taken note, and pulled in its horns. It is this unregulated and basically opaque business which poses the biggest threat to our economy and our markets. If the summer's volatility was a canary for this industry, it will have been well worth the shaky ride.

#### **GIPS Performance Disclosure**

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Annualized Net of Fee Returns as of September 30, 2007



PRELIMINARY RETURNS

Quarter Composite Net of Fees\*

MHI Income-Equity*	(4.2)%
50/50 R1000 & Long Treas	3.3%
Russell 1000	2.0%

12-Month Composite Net of Fees\*

MHI Income-Equity*	10.2%
50/50 R1000 & Long Treas	10.5%
Russell 1000	16.9%

10-Year Annualized Composite Net of Fees\*

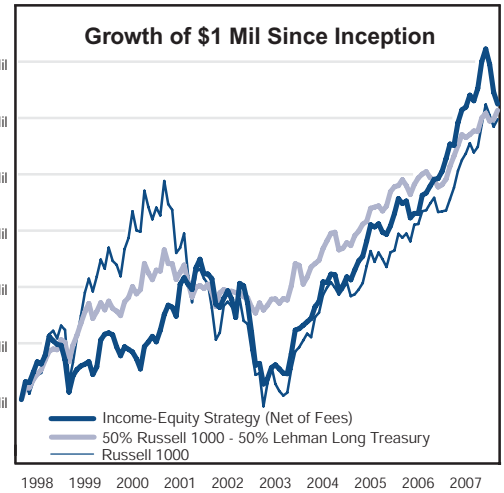
MHI Income-Equity*	7.0%
50/50 R1000 & Long Treas	7.5%
Russell 1000	6.9%

The third quarter defied financial history in many ways—it’s been seven decades since the credit markets last froze in place—and our portfolio defied its typical or historic relative performance (over the past five years, 59% of the Russell 1000 downside, 83% of the upside), landing near the back of the pack. Of course it’s a plus for a portfolio to offer low correlation, though bittersweet at times like this. Relative to the broader indices we are reminded of the fourth quarter of 2005, when the large-stock led indices rose and our portfolio fell, investors at the time were fleeing yield stocks out of prophylactic concern about incipient rising interest rates. We felt defensive then, proclaiming investors had erred, but that moment did prove the beginning of an excellent year—recovering the earlier quarter’s performance gap and more. Just now our knuckles are a little sore from knocking wood in hopes that history repeats, or at least, as people have been saying lately, that it rhymes.

In August, to put it simply, both hedge funds with yield-oriented strategies and carry-traders who borrow at low interest to buy assets offering high yields, were suddenly forced to retrench due to a contracting credit market and/or losses precipitated by the sub-prime mortgage industry collapse. In other words, a huge margin call arose—having everything to do with the liquidity position of the players and nothing to do with the fundamental situation of the stocks that were sold. Stocks were sold because the credit markets had shut down and equities were the most easily available source of cash.

This was fairly obvious from the picture of stocks that typically traded in a high/low range of a percent or two a day suddenly expanding their range to ten percent and more a day with no fundamental news to explain it. In response to our probing, managements assured us business was moving forward as usual.

Generally speaking, and confirmatory of this pattern, our lower-yielding stocks were our best performers for the quarter (some actually had extremely strong quarters) while our highest



yielding stocks caused the greatest total-return degradation. As in the third quarter of 2005 higher yielding stocks didn’t bounce back from the market setback nearly as quickly as the large-caps, leaving them a drag on the portfolio on both the downside and the upside for the quarter. Having seen this pattern before we believe it’s transitory.

PORTFOLIO HIGHLIGHTS

We had strong stocks from diverse fields during the quarter. Diana Shipping joined a generally strong dry bulk-shipping group with a gain of over 20%. This is clearly a beneficiary of the famous global economic boom, as well as of tight conditions in the shipping industry that may not last forever. Proctor and Gamble finally broke out to new all-time highs after remaining stuck in a tight trading range for at least two years, some would say four. PG is a clear beneficiary of the weaker dollar due to its strong international revenues. Similarly, Colgate rose over 10%, with Johnson and Johnson and Schering Plough not far behind.

Late in the quarter we bought Nucor for a quick gain of about 8%. This outstanding steel maker is also outstanding for its share-the-wealth attitude and good yield, as well as being one of the few steel companies that passes generally accepted social screens. In July we bought Paychex after it increased its dividend by 50% and thereby entered our universe. As

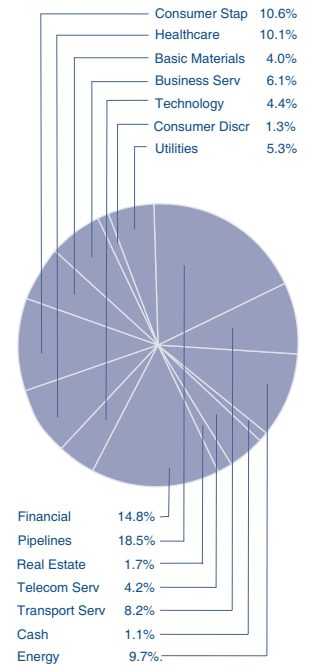
a kind of affirmation of our process the stock continued strong all through the July-August debacle and stayed steady in September. We increased our weight in NiSource, continuing to believe in both its internal improvement and its attractiveness to an acquirer, with its unique pipeline assets. We also increased Brookdale Senior Living (it had been irrationally treated in the selloff) and CapitalSource (same reason). In both of these cases insiders had also made large purchases at the lows—hardly a sign of some secret problem not yet made public.

Some of our buying was a result of what we might call “involuntary selling.” Like United Utilities earlier in the year, Bayer AG, which had been one of our best stocks and one of the best performers worldwide in the health industry, decided to delist from the NYSE and withdraw from SEC registration, rather than continue to fulfill the burdensome requirements of Sarbanes Oxley. Since we don’t hold unregistered companies, we had to sell, if unwillingly. Travelers had been owned earlier through a high-yielding convertible preferred and we were awaiting an appropriate sell point for the common. When it became clear that the property-casualty insurance industry was entering a static period due to the end of an era of price increases, we let the common go in early July. Finally, Schering-Plough’s convertible preferred also matured, giving us the common at a low yield and a mercifully high price, which we booked. There may be another potentially useful convertible for this one, but at the moment it is plagued by ragged liquidity.

As noted, our weak performers were for the most part our highest yielding stocks, stocks that in our opinion were caught in the liquidity switches of a handful of yield-oriented and over-leveraged players. Though painful in the short term, this storm has actually been productive, since it compelled us to subject our holdings to a kind of maximum-pressure scrutiny and cross-examination. While there are drags on growth going forward that apply to all companies, we just don’t see anything in this group of companies or in the individuals that

would justify sharp discounts from previous pricing, which was not high to begin with. Since information at publicly traded companies is always behind an arras to one degree or another, we often examine the behavior of insiders—company executives and directors—who know most about what is going on, to infer whether there is underlying trouble or merely psychotic investors involved in a stock price decline. Bear in mind that net selling is “normal” for insider trading, since equity is a major method of compensation and often those compensated with stock need to spend some actual cash. Ordinarily, in many if not most companies there is very little insider selling *or* buying in the open market. However, of our bottom ten performers, an astonishing seven saw significant insider buying this past quarter. Of the three that did not show buying, there was no selling. In terms of management putting its money where its collective mouth is, we think this is good evidence that management believes what it has told us in our fact checks.

Continued on back cover...



Income-Equity Strategy Composite Performance			
GIPS Composite Disclosure, Net and shown in US \$			
	Income-Equity Strategy Composite Includes MLPs	Income-Equity Strategy Composite No MLPs	Russell 1000
Period to Date (3mths to 9/30/07)	-4.2%	-2.3%	2.0%
1 Year (ending 12/31/06)	22.7%	20.7%	15.5%
3 Years per annum (ending 12/31/06)	12.9%	11.9%	11.0%
5 Years per annum (ending 12/31/06)	8.0%	Not enough data	6.8%
7 Years per annum (ending 12/31/06)	8.3%	Not enough data	1.7%

The Income-Equity Strategy Composite focuses on multi-cap, high-quality, high-yield dividend-growth investments across the broad market, including American Depository Receipts. The No MLP portfolio excludes exchange traded Master Limited Partnerships.

FUNDAMENTAL CHARACTERISTICS

Yield	5.8%
Proj Dividend Growth	8.4%
Payout Ratio	57%
Market Cap	\$40.6 Bil
Price/Book	2.7
P/E Ratio	15.3
S&P Rating	BBB+
Beta*	.55
R-Squared*	50.4%
Standard Deviation	11.5%

\*Relative to S&P 500, 9/30/97 - 9/30/07 (Weighted Averages)  
Sector pie chart is taken from a representative account. Information is supplemental to the performance disclosure information.

*“We prefer to focus on individual companies and the industries that set headwinds or tailwinds for them.”*

Last quarter we suggested the environment might become “fussier,” as so many stocks had left the zone of historical undervaluation behind, and many situations were ripe for profit-taking (“almost any moment contains elevated profit-taking potential”). We’d said we might possibly wind up with more cash than normal, but that never occurred as there was massive demand for equities waiting on the sidelines, willing to enter the market in relatively short order upon a price decline, even in the face of a clearly non-trivial dislocation of the credit markets. We wonder just what kind of catastrophe it will take to blunt the avaricious appetite of equity buyers worldwide in the kinds of stocks we hold in this portfolio. So far no problem that has arisen has managed to stem the tide for very long.

In particular, the companies we hold have been notable in reporting great earnings and revenue gains, and have transferred an acceptable portion of those earnings to shareholders through dividends and dividend increases. Investors and Wall Street strategists like to think in terms of cycles, and to predict that a given economic trend will soon end, to be replaced by another one. We prefer to focus on individual companies and the industries that set headwinds or tailwinds for them.

**PRELIMINARY RETURNS**

**Quarter Composite Net of Fees\***

Rising Dividend Plus*	(2.5)%
Russell 1000	2.0%
S&P 500	2.0%

**1-Year Composite Net of Fees\***

Rising Dividend Plus*	11.8%
Russell 1000	16.9%
S&P 500	16.4%

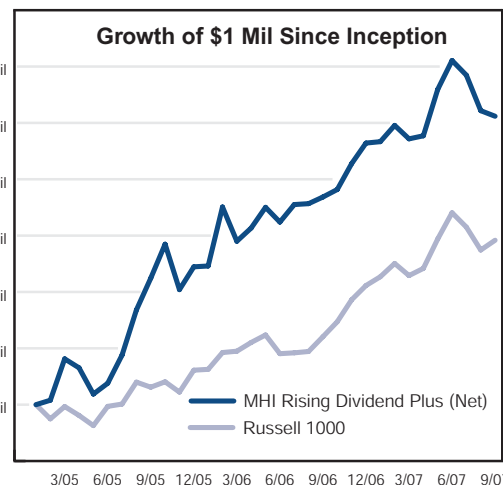
**Since Inception (12/31/04)**

**Annualized Composite Net of Fees\***

Rising Dividend Plus*	17.1%
Russell 1000	11.3%
S&P 500	10.8%

**PORTFOLIO HIGHLIGHTS**

The recovery interest in August and September seemed to focus on large-cap stocks, and that’s the source of the stronger stocks in our portfolio. Indeed, many had been a bit asleep in terms of participation in previous market strength, so there is a hint of a “cyclical” movement toward larger stocks now. On the one hand, such a trend could last for years given the relative quiet of these stocks in recent times. On the other hand, we’ve often seen such activity in a flight to quality moment, only to wane as investor tastes become racier. It’s not easy to generalize about the portfolio, but certainly most of the best stocks had at least a taste of benefit from the notorious global economic boom.



Air Products definitely qualifies on that score. The company reported a nearly 10% upside earnings surprise, guided the full year up, and announced an additional \$1 billion buyback. Emerson Electric also beat estimates, and noted the favorable effects of currency exchange rates. Intel continued on its roll, with increasing earnings, revenues, and margins, and cited stronger than expected worldwide demand for its products. Teva reported 15% better than analyst estimates, and provided an upside revenue surprise as well. 3M also beat estimates, benefiting from a weak dollar. Johnson & Johnson and Proctor and Gamble both emerged from stock-price doldrums to lead the market higher, as investors turned toward reliable global brand leaders with international exposure.

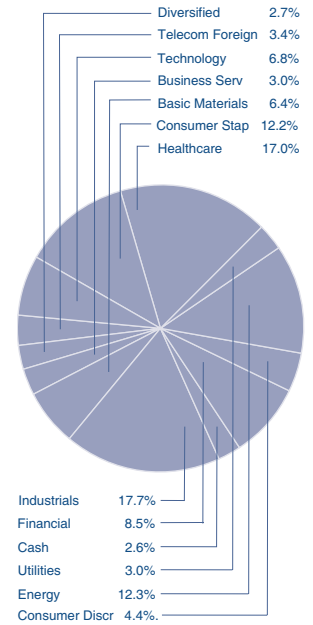
On the downside, last quarter’s leader Whirlpool gave back some gains as investors became spooked by housing market exposure—the same thing that spooked them last fall. But the company’s results have belied this fear, and it has been hitting on all cylinders despite a weak business background. Trinity had a bad quarter for no reason we can think of, and it remains a solid infrastructure play in our minds. Ensco earnings were hurt by softness in the Gulf of Mexico market—though the real appeal of this company is its deepwater

international operations. Staples lost almost 10%, and we are mystified by the decline from already extraordinarily low levels. It dominates the office products category, with only one real competitor nationwide, and growth has been fine, yet it is valued lower than an ordinary distribution utility. We'd buy the whole company if we could here, and we would hardly be surprised if someone else decides to do so.

We had some buys and sells, mostly in September as the dust settled somewhat. Early in the summer we bought Paychex after the company raised its dividend by 50% and instituted a large share buy-back. This is almost an automatic buy in our strategy, and we made room for it by selling our remaining Scott's Miracle Grow (we already got the miracle growth from it). We sold GlaxoSmithKline on justified concern that the FDA would treat Avandia harshly. We bought Medtronic, a previous holding in this portfolio, at an historically low valuation despite a constant stream of positive news flow and approvals from the FDA. We also viewed the stock's technical situation very favorably, believing conditions were ripe for a move past resistance, which did come to pass and which augurs well for the appeal of the stock to investors in the future. We added some metal stocks in September, as we had been light on materials and this is a sector whose story is clearly not yet over. Timing may not be everything in investing, but it sure helps, as Allegheny Technologies and Nucor were both up about 15% from our buy price. We added Turkcell, an idea borrowed from our utilities portfolio. Here too, the timing was helpful (or lucky), as it rose some 10% within, in truth, a matter of days. Our purchase of McCormick, the famous spice company, was less well timed—investors weren't thrilled with its earnings report (we bought an opening position just ahead of the announcement), giving us a quick 6% loss. Various trims of otherwise favorable stocks and sales of smaller positions enabled these purchases.

LOOKING FORWARD

Generally, we think prospects for our holdings are fine just now. We're somewhat concerned about investors' apparent quest for the new cycle or new leadership—so we read—and this portfolio has a market-driven element that can and will lean in those directions a bit (though the core remains agnostic). But it seems to us that investors, after the events of last February and this summer, are likely to be more perfidious than they were, and we're hoping to add value going forward through timely trimming of successful positions.



FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	1.6%
<b>Proj Dividend Growth</b>	13.6%
<b>Payout Ratio</b>	25%
<b>Market Cap</b>	\$44.7 Bil
<b>Price/Book</b>	3.6
<b>P/E Ratio</b>	17.9
<b>S&amp;P Rating</b>	BBB+

(Weighted Averages)  
Sector pie chart is taken from a representative account.  
Information is supplemental to the performance disclosure information.

Rising Dividend Plus Composite Performance		
GIPS Composite Disclosure, Net and shown in US \$		
	Rising Dividend Plus	Russell 1000
Period to Date (3 mths to 9/30/07)	-2.5%	2.0%
1 Year (ending 12/31/06)	17.7%	15.5%
Since Inception (1/1/2005 to 12/31/06) per annum	21.1%	10.8%

The Rising Dividend Plus Composite is a mid- and large-cap core strategy focusing on companies in which dividend growth is the key variable. The Russell 1000 Index offers investors access to the extensive large-cap segment of the US equity universe representing approximately 92% of the US market.

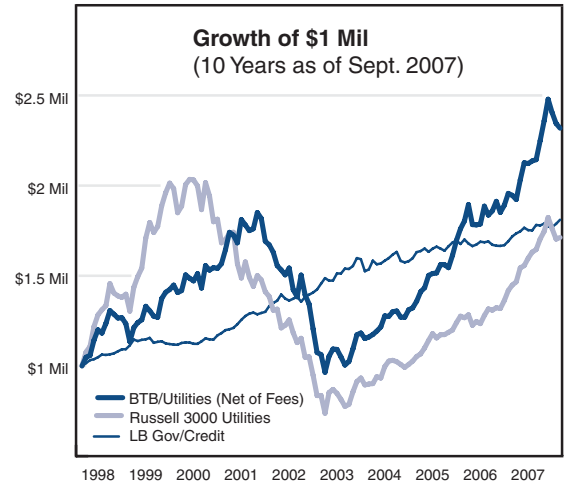
*“Either the U.S. is much riskier relative to the rest of the world than we like to think, or investor ‘appetite for risk’ remains healthy in certain areas and remains focused on the much greater growth opportunities that developing economies imply.”*

Utilities, like everything else, took a knock during the July/August turbulence, but it was relatively mild, and both energy and telecom utilities seemed to be on investors’ shopping lists as the dust settled. We were a little surprised, since many are the subject of merger activity or imagined activity, and arbitrageurs lost their nerve along with the crowd over the summer. Too, utilities have often been the tools of various long/short hedge fund strategies, and many came unwound during 1998’s turmoil, for example, but not this time. Very good relative performance during September suggests that investor confidence in this sector has not been seriously damaged by troubles in the credit markets.

Many are saying that the market reflects a reduced appetite for risk among investors. While we can’t disagree, the trends are not monolithic, for among our top ten performers seven were foreign telecom companies, and, of those, six were from countries which used to be called emerging and have now graduated to “developing.” In the past, at any rate, the countries involved were perceived as more risky than the U.S. or Euroland—though the actual companies were modestly valued compared to domestic telecoms (which was the primary reason for our exposure there). Either the U.S. is much riskier relative to the rest of the world than we like to think, or investor “appetite for risk” remains healthy in certain areas and remains focused on the much greater growth opportunities that developing economies imply. And there’s really no more conservative way to participate than through local utilities and telecom companies, which are frequently treated more generously and protected more paternalistically than their U.S. counterparts.

**PORTFOLIO HIGHLIGHTS**

Many of our foreign telecoms were first purchased in 2005 (one in 2004), and while they have been excellent performers all through our



holding period, the ripest fruit arrived this year. As one might expect, China Mobil (the 2004 purchase) has led the way, with a 52% gain this past quarter and (gulp!) a roughly five-fold gain since first purchase. It’s definitely a candidate for trimming—once again. PT Telekomunikasi Indonesia may be hard to pronounce, but we know how to say 13% for the quarter, bringing our two-year gain to over 100%. In between, this quarter, was Turkcell—benefiting from a positive election in Turkey and a new era of stability there—Brasil Telecom, Philippine Long Distance, and America Movil, all ranging up to 30% for the quarter. We also bought Telefonica de Espana in September for a 14+% gain. And in this sector AT&T and Verizon also made positive contributions. We did not set out to take a weight in foreign phones, but using these latter two as a valuation benchmark, and doing our best to adjust for political risk as well as higher volatility, we found that the valuation combined with growth potentials of these foreign companies was simply compelling compared to our two majors fighting it out in an already-penetrated and mature market.

Our position in Cypress Semiconductor, held because of its majority ownership in solar energy leader Sunpower, rose 25% and has now also doubled since purchase (at a small weight)

**PRELIMINARY RETURNS**

**Quarter Composite Net of Fees\***

BTB/Util*	1.4%
Russell 3000 Utilities	0.4%
S&P Utilities	1.9%
LBGC	3.0%

**1-Year Composite Net of Fees\***

BTB/Util*	26.8%
Russell 3000 Utilities	20.6%
S&P Utilities	21.1%
LBGC	5.1%

**10-Year Annualized Composite Net of Fees\***

BTB/Util*	8.8%
Russell 3000 Utilities	5.1%
S&P Utilities	8.6%
LBGC	6.0%

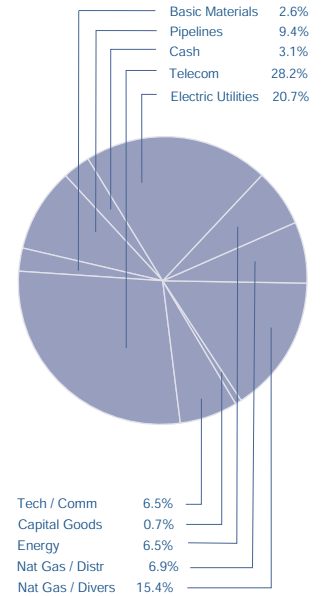
in 2005. The other two important leaders in the portfolio were gas producer Ultra Pete and hybrid Equitable Resources. In both cases these companies rose on the merits of their own growth and development—it certainly wasn't due to the price of natural gas, which was a big disappointment during the summer.

More traditional utilities didn't fare as well. Sierra Pacific (SRP) was off more than 10% primarily on profit-taking after its long and strong recovery run. The company reported disappointing earnings, but that was well after the price decline, and indeed the stock rose a bit after the report, which included a surprisingly large rise in revenues—raw material, we think, for future earnings growth. Kinder Morgan Energy Partners(KMP) was nearly as much of a drag, hurt by an inexplicable failure of investors to generate interest in the MLP sector generally, despite declines that were unwarranted by any change in fundamentals. Indeed, during August and September several MLPs went right into the credit quagmire and rolled out offerings with yields not much higher than long-term Treasury Bonds. We expect to see both KMP and SRP on the leaders list before long.

Other utilities showed minor losses and gains, with little fundamental news behind price changes. Generally, the newsflow picture was dominated by upside earnings and revenue surprises. We took the opportunity to reduce weights in various stocks and increase weight in higher conviction names such as AT&T, El Paso, Spectra Energy, NiSource, and AES. Natural gas stocks apart from Equitable and Ultra Petroleum were a modest drag as well, suffering under poor natural gas pricing though the companies business plans continue to progress.

LOOKING FORWARD

We expect some of the weaker portfolio members this quarter to help rather than hinder returns going forward, as investors recognize that reduced valuations were not reflective of underlying business fundamentals, and, in the case of the gas stocks, as prices firm for winter. We are likely to trim back our holdings in foreign phones, certainly in those whose valuations reach parity with domestic phones and therefore provide no discount for political and volatility risk. We like the increased weights we have in selected stocks now, and we are constantly on the lookout for companies that can benefit from the obvious need of the electric utility industry to build out transmission and generation infrastructure. Returns have been strong, strong enough to raise concerns about consolidation or correction. But we continue to think there are many interesting opportunities in the sector. And this past quarter the large-caps have proven that investors have reasonable confidence in the utility industries even in uncertain times.



Better Than Bonds/Utilities		
Composite Performance		
GIPS Composite Disclosure, Net and shown in US \$		
	Better Than Bonds/Utilities	Russell 3000 Utilities
Period to Date (3 mths to 9/30/07)	1.4%	0.4%
1 Year (ending 12/31/06)	18.8%	29.4%
3 Years per annum (ending 12/31/06)	18.4%	17.1%
5 Years per annum (ending 12/31/06)	6.6%	5.0%
7 Years per annum (ending 12/31/06)	5.4%	-3.4%
10 Years per annum (ending 12/31/06)	8.7%	5.1%

The Better Than Bonds/Utilities Composite focuses on opportunities in the broad utilities industry seeking to provide growth and income for total return investors. Russell 3000 Utilities index is comprised of over 200 utility stocks that are included in the Russell 3000 Index

FUNDAMENTAL CHARACTERISTICS

Yield	2.2%
Proj Dividend Growth	7.1%
Payout Ratio	34%
Market Cap	\$44.2 Bil
Price/Book	3.1
P/E Ratio	19.9
S&P Rating	BBB+
Beta*	0.62
R-Squared*	42.5%
Standard Deviation	14.2%

\*Relative to S&P500, 9/30/97-9/30/07 (Weighted Averages)  
Sector pie chart is taken from a representative account. Information is supplemental to the performance disclosure information.

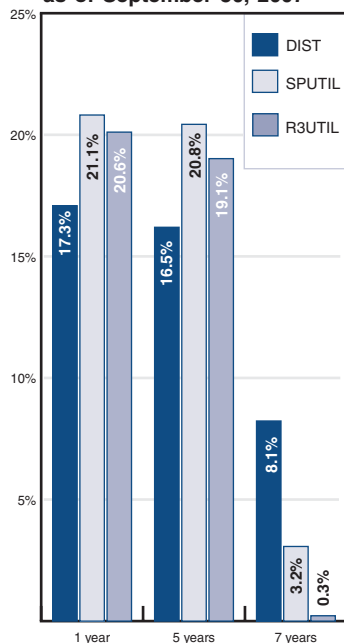
We had a very stable portfolio, which is quite notable since the portfolio is dedicated to potential consolidation stocks and the world of deals suffered some body blows during the quarter. Indeed, in other areas, such as REITs and varied industrials, deal candidates collapsed and even announced-deal stocks encountered problems both real and imagined. Our balance of positive and negative performers with no outstanding negatives augurs well for the future, considering the ample opportunities for mishap that the quarter presented.

This is especially heartening because the potential momentum from financial players has to be viewed as vanished until proven otherwise now, as sources of leverage are going to be reluctant and skeptical partners for a period. This is even more salient in our area because these deals require more time to obtain regulatory approvals. However, the weak dollar works markedly in favor of this portfolio, since foreign utility buyers are looking to the long term, and they know that US regulated assets are irreplaceable. There are only so many distribution assets in mature countries that these companies can buy. That's why both National Grid (completed takeover of our Keyspan) and Iberdrola (pending deal for our Energy East) are even willing to hook up with New York State regulators—the proverbial difficult mother-in-law that comes along with a productive marriage.

## PORTFOLIO HIGHLIGHTS

BCE (formerly Bell Canada) reached a definitive agreement to be acquired, and the stock added almost 6% this quarter, after dipping mid-quarter along with many deal stocks when frightened investors gave up on arbitrage situations. It was obviously in play when we bought it and had already risen; nevertheless we've managed a roughly 16% gain in nine months—an indication that in this part of the market one can still trade for opportunities. Elsewhere on the deal front it

Annualized Net of Fee Returns as of September 30, 2007



## PRELIMINARY RETURNS

**Quarter Composite Net of Fees\***

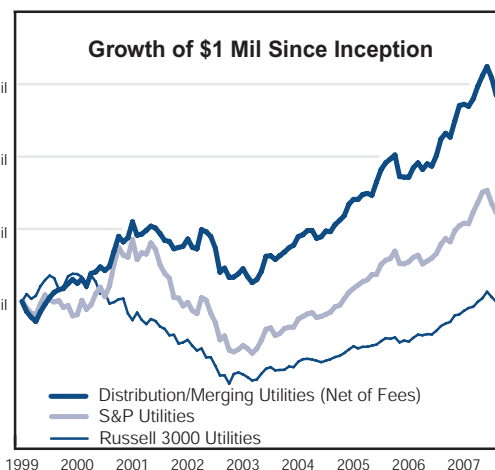
Distribution*	(1.6)%
Russell 3000 Utilities	0.4%
S&P Utilities	1.9%
S&P 500	2.0%

**1-Year Composite Net of Fees\***

Distribution*	17.3%
Russell 3000 Utilities	20.6%
S&P Utilities	21.1%
S&P 500	16.4%

**7-Year Annualized Composite Net of Fees\***

Distribution*	8.1%
Russell 3000 Utilities	0.3%
S&P Utilities	3.2%
S&P 500	2.6%



was assets rather than companies that were the subject of transactions, including a sale by PPL of its fairly small gas and propane distribution system, a sale by Kinder Morgan to ONEOK of some pipeline assets, a purchase of more production assets by El Paso, Black Hills' acquisition of Aquila's gas utility assets, and the like.

Our biggest winner was fast-growing Turkcell, which participated fully in a raging market for developing market telecom stocks—boosted here by a successful election in Turkey and significant acquisition rumblings among Russian wireless companies. Telecom Italia also did well, recovering from last quarter's weakness. Elsewhere our leading stocks included a collection of some of the most likely acquisition candidates, including CH Energy, Nstar, Piedmont, and Xcel, as well as stocks with existing offers on the table, like Energy East, and Alltel.

Most stocks in our portfolio reported better than expected earnings, led by a shockingly good report from WGL Holdings, which beat expectations by \$.21 and beat revenue expectations by about 30% (!)—not too shabby for a distribution utility.

On the downside, losing stocks were minimal, which was a real positive this past quarter, considering how little support there was from the utility large-caps and how likely many

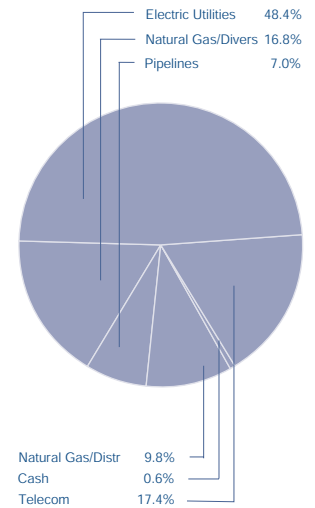
of these stocks were as sources of cash for leveraged funds. Too, those with pending deals avoided anxiety price declines, and only Sprint lost ground among the stocks with no deal but deal buzz. In addition to Sprint, the worst performers included Enbridge Energy Management, which suffered from the general malaise in the MLP space, Sierra Pacific, which suffered only from profit-taking and moved down to a hot, hot buying opportunity price. PNM (formerly Public Service of New Mexico), on the other hand, reported a wretched quarter and guided down for the year by at least 20%. The only good news here is that it was a small position in the portfolio and that it has declined so much (about 40% from 2007 high to September lows) that it now sells at book value, which could be tempting asset-value bait for any one of several neighboring utility acquirers. Some portfolio accounting systems might show a big loss for Hutchinson Telecomm, but that is because it paid a special \$12.94 dividend on June 29—actually the stock was up for the quarter.

LOOKING FORWARD

Financial buyers—private equity and hedge funds and such—aren’t likely to have much of an impact in this space for a while. However, as the credit-market returns to some semblance of normalcy in doing daily business, we suspect that companies with regulated and stable repeating business may once again become the keystone for financial deals. The timetable on that is open-ended, though, and near-term activity is doubtful. However, our crystal ball shows more acquisition activity in our distribution companies by foreign companies, both those already in the field and those looking for a toehold. These companies understand what we have often said, and what is often ignored in countries with a history of aggressive production economies, like ours.

Marx was wrong. Power does not reside in control of the means of production. Rather, it resides in the control of distribution—which is now cheap in global terms, thanks to a weak dollar.

Deals or no deals, our companies will continue to book steady profits from ongoing regulated and inelastic business. For some time we thought this group had gotten ahead of itself on valuation, pulled higher by a kind of mania for the large-caps. But earnings and cash flows have slowly grown into their pricing. We expect more of the same along with steady dividend growth, and we’re less concerned about risk. Investors, we think, are once again being paid to wait, with a favorable risk/reward relationship.



Distribution/Merging Utilities Composite Performance		
GIPS Composite Disclosure, Net and shown in US \$		
	Distribution/Merging Utilities	S&P Utility
Period to Date (3 mths to 9/30/07)	-1.6%	1.9%
1Year (ending 12/31/06)	27.1%	21.0%
3 Years per annum (ending 12/31/06)	17.7%	20.6%
5 Years per annum (ending 12/31/06)	10.5%	9.2%

The Distribution/Merging Utilities Composite focuses on investments in public securities of undervalued small and mid-capitalization utility companies subject to acquisition. The S&P Utility Index is an unmanaged, market-value-weighted total return index of all utility stocks in the S&P 500.

FUNDAMENTAL CHARACTERISTICS

Yield	3.0%
Proj Dividend Growth	6.6%
Payout Ratio	45%
Market Cap	\$10.8 Bil
Price/Book	2.1
P/E Ratio	17.3
S&P Rating	BBB+
Beta*	0.45
R-Squared*	25.0%
Standard Deviation	12.2%

\*Relative to S&P 500, 9/30/00 - 9/30/07 (Weighted Averages)  
Sector pie chart is taken from a representative account. Information is supplemental to the performance disclosure information.

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.

## Income-Equity Strategy continued from page 5...

So why didn't summer's weak ones bounce right back and become the strong? As we've said, this is not the first time presumably stable stocks became caught up in the machinations of some players whose eye was not on the fundamentals. We saw it in the fall of 2005, and we saw it in August of 1998—an eerily similar period, in our view. In both cases it was large-caps that felt the inflows of money first when the markets resumed their previous greenlit position, and it took some time for the natural buyers—investors who want stable companies that provide high dividend yields—to overcome a kind of shyness induced by unexpected volatility. Basically, the answer to any raised eyebrow is “do the math.” When dividends are near 10%, it does not take long to recover your full investment from yield alone, while still retaining full control of the asset. There is a large constituency of investors who care about this little exercise in arithmetic, and they will be out shopping again before long, we think.

## LOOKING FORWARD

It's the same old story. Companies with a stable business that can pay a high and rising dividend form the basis for a “compounding machine” in which the value of the principal that produces income increases as the amount of income increases. Sometimes a portfolio of such stocks will provide better short-term returns than all the rest, sometimes it will lag. But in today's world it will never lag for long, because it is one of the few sources of income at investment grade that is higher than Treasury Bond current yields, **and it is perhaps the only source of high income that rises to offset inflation over the years.** There are quite a number of identifiable groups of investors who need that.

Current yield as of 9/30/2007 was 5.8%, with a projected growth of yield of 8.4%. As always, we remind investors that due to dividend growth and special dividends, our realized 12-month cash yield has typically been significantly higher than the stated “current yield,” though we can never know in advance if it will in fact be higher, or how much so.

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