

MARKET OVERVIEW

THE STRATEGIES

BETTER THAN BONDS / UTILITIES

A bond alternative and moderate equity approach focusing on opportunities in the broad utilities sector: electric, gas, telephone, sanitation and water.

A conservative socially responsible strategy offering growth and income for total return investors.

BETTER THAN BONDS / INCOME

A fixed income alternative which utilizes reliable companies from across the broad market. Stocks are conservative, high quality, high yield, and are projected to have a rising stream of income.

THE SBI PORTFOLIO

A mid-cap strategy combining value with moderate growth that utilizes stable, moderate growth stocks from all sectors and emphasizes companies with strong dividend growth as well as unique fundamental characteristics. Based on the strategy detailed in Lowell Miller's book, *"The Single Best Investment."*

ALPHA-BASED STRATEGY

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

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Hold the champagne! By the end of the second quarter it finally appeared that the flow of funds in the equities markets had become more rational, and that the long drought for value-oriented stocks was finally over. But in July the music suddenly stopped and the markets reverted to their past bad behavior. Value stocks were joined by seasoned growth companies, companies in every capitalization size, and in virtually every industry. Indeed, with the exception of a handful of new era technology companies, there were no positive returns to be found. No domestic index nor any fund category rose in value during the quarter, creating a rout that was total and broad if not terribly deep.

Like many participants, we'd thought the second quarter marked a new beginning for the broader market. Perhaps it was too enthusiastic to assume smooth sailing at the first signs of change.

For the quarter did produce a further divergence between the averages and the true average stock: even though the averages declined, the true average stock was even worse. On the following page is a recent chart prepared by The Bank Credit Analyst comparing the S&P 500 with the cumulative advance/decline summation for all markets (NYSE, AMEX, NASDAQ). Note that even though the index has struggled higher, stocks have essentially been in decline since the spring of 1998, a phenomenon that has gathered momentum in 1999. (When the composite advance/decline line is declining it means that the majority of stocks are declining.)

Some melancholy factoids regarding this market can accompany the chart. For example, the Value Line Index, one of the better broad-based indices, was down nearly -5% year-to-date as of September 30, and was down over -5% average annualized for the past two years. A -10.3% quarter certainly didn't help matters, and it's a much more accurate measure of the broad market than the Dow Jones Industrials or the S&P 500. This year some two-thirds of all stocks show negative returns for the year. The average S&P 500 stock has fallen roughly 25% from its yearly highs, and more than half the S&P sectors are down for the year. Last quarter we quoted some of the wisdom of Warren Buffet, an investor with one of the best long-term records extant. Not only is his Berkshire Hathaway stock down, but key positions such as Coca Cola, Gillette, and Disney suffered average losses of worse than 20% last quarter alone. So it's been a general market that can make wise men weep, and seem not so wise, at least for the moment.

But it's important to remember that times change in the market; things have not always been thusly skewed. Reversion to the mean is one of the few laws in the market that can be counted on over the long term. You may recall we printed long-term returns from a broad variety

“...it’s been a general market that can make wise men weep, and seem not so wise, at least for the moment”

Beneath the Indices: A Bearish Phase



of asset classes (such as small-cap, large-cap, international, etc.) in our first quarter report: in the end, there was little difference between any of them. During the second quarter everything appeared to change, and though the effect was short-lived, it will return. For investing really is about investing. Though profits are not delivered with regularity or like clockwork, over the long term, stocks with sound values reward investors. If there were not outlier or “wacky” periods like the one we’ve been through, it would all be too easy.

We think much of the market turmoil is fueled by investor uncertainty regarding the course of interest rates, and is compounded by investor uncertainty regarding Y2K. Historically, stocks do not do well when interest rates are rising. This is especially true when valuations are “high” (as we know, the market seems “high” even though many stocks are brushing intermediate-term bottoms), such as in 1987. Yet the animal spirits of investors in speculative stocks have in some niches of the market produced good rallies, lending a kind of schizophrenic quality to the landscape—and further disconcerting already nervous investors.

Too, the Y2K problem presents the ultimate uncertainty—an event never before seen in economic history, whose consequences both in the real world and in the financial markets are utterly unknown. Many pundits have offered predictions of what will happen, down to the day in some cases, but no one really knows, and everyone knows that no one really knows. So even

good values languish in the face of investor unwillingness to make bets in the face of the twin headwinds of Y2K and rising rates. However, both these situations are relatively finite. Y2K will come, and it will be what it will be. Like 1987, in the long-term scheme of things it’s not likely to be more than a blip on the charts. And the most probable scenario, in our view, is that either a slowing in the inventory buildup that has occurred in anticipation of Y2K, or the actual consequences of Y2K, will conspire to brake the economy enough for bond investors to become once again emboldened and match bond rates closer to actual low inflation rates—setting a better tone for all the financial markets (we believe long-term bonds should yield closer to 5% than the current 6.14%).

Our assumption is, of course, that the eventuality of Y2K brakes the economy but does not break it. Here we are merely going with the flow, as nothing has been able to slow this expansion to date. There is a caveat, though: a decline in bond rates at the end of this year or early next year would risk creating an inverted yield curve (with short rates higher than long rates), and this circumstance is also a negative for equities.

So there’s enough to worry about this quarter to place a ceiling on any rallies (and quantitative measures of sentiment are also not negative enough to imply a strong rally), while investors with a longer time horizon are interested in buying stocks that have declined with the knowledge that the current state of affairs is transient. That’s a recipe for a choppy market, albeit with a potentially positive bias as some of the excesses of the third quarter are corrected, yet with just as much potential for a swoon at the end of the year. Here’s a moment when analysis and historical rules of thumb don’t mean a great deal, a moment when long-term investors can cultivate the character quality of passivity that’s necessary for long-term success. □

SELECTED INDICES

	3 rd Qtr'99	12Mo
S&P 500	-6.25	27.80
Equity Inc	-8.60	12.29
Util Fund	-3.26	14.68
DJUA	-4.96	0.87
LB Treas	-0.14	-7.68
LBGC	0.54	-1.62
S&P 400	-8.40	25.49
Val Line	-10.33	8.98
Rus 2000	-6.32	19.07

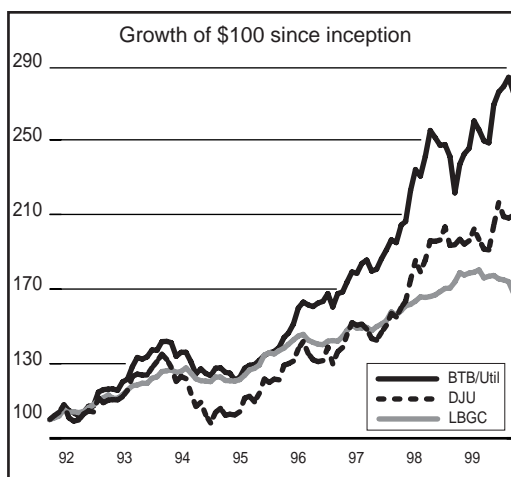
S&P 500 = Standard & Poor's Index
Equity Inc = Ave Equity Income Fund*
Util Fund = Ave Utility Fund (Morning Star)
DJUA = Dow Jones Utilities Ave
LB TREAS = Lehman Long Treasury
LBGC = Lehman Bros. Gov/Corp Bonds
S&P 400 = S&P Mid Cap Index
Val Line = Value Line Price Index
Rus 2000 = Russell 2000
*Lipper

Last quarter we suggested that further gains might be in store for our portfolio during the third period, as many stocks were nicely positioned. While our stocks didn't really make additional progress, under the circumstances the quarter proved a triumph of sorts. In the face of a negative quarter for fixed income and losses of more than 6% for both the Dow Jones Utilities and the broad stock market, we were able to squeak by with no loss, thus dodging a bullet this time. The "return to normalcy" which seemed incipient after the second quarter faded; nevertheless investors treated our issues rationally. Relative to the broader list of utilities, our stocks were impeccable, adding about 450 basis points of return to the utility indices. We've also suggested for some time that the values in our portfolio imply performance that is at least competitive with the S&P 500 (in addition to being "better than bonds"), and on a year-to-date basis we're noticeably ahead of the "big" stocks—a condition which hasn't pertained for some time during the many recent quarters of big-cap growth mania.

Given that the possible upside surprise in the bond market—upon which we'd speculated last time—failed to materialize, it would also appear that further evidence of the disconnect between interest rates and our particular slant on utilities has been deposited. At this point we now show positive returns despite two increases in short-term rates by the Federal Reserve, and year-to-date long-term bond total returns below -5%. We continue to be intrigued by this new status as a yield investment that is not bound by changes in interest rates, though to be sure there will be times when rising rates affect our issues just as they affect all financial instruments. Still, the idea that *a yield portfolio does not have to go down* when interest rates rise is appealing, and there is a mounting backlog of quarters which seem to point to this conclusion.

Last fall we pointed out that investors in long Treasuries and the large-cap electrics were "out on a limb." At that point those stocks had been used in the equity markets just

as the long Treasury had been used in the credit markets. (You may recall that long Treasuries were strong in 1998 even though the non-US government part of the bond market was quite negative.) Large-cap electrics spiked up to levels near 20 times earnings and prices that were clearly



unsustainable—levels that reflected panicky parking by naive though clearly large investors—and bond yields were driven down to 4.70% (October 1998) by investors hiding from the uncertainties of a global currency crisis. Somebody was buying at those levels, but we offered the fairly easy prediction that large electrics would fade in favor of quality utilities with good finances and long-term records of moderate but consistent earnings growth. Indeed, the trailing 12-month returns for the Dow Jones Utilities is only .87% (despite the presence of 8% weights in good-performing Enron, PECO, and takeover Consolidated Natural Gas), while our trailing 12-month return is 17.18%. As for long-term bonds, the 12-month return is negative at -7.68%.

And once again, we continue to outperform many categories with higher expected returns, at least within the conventional asset class stereotypes. Our one, three, and five year returns are better than our normal benchmarks, but also better than midcap funds, convertible

"...over the past 25 years utilities have been the second best performing sector in the market, for both large stocks and the broad market."

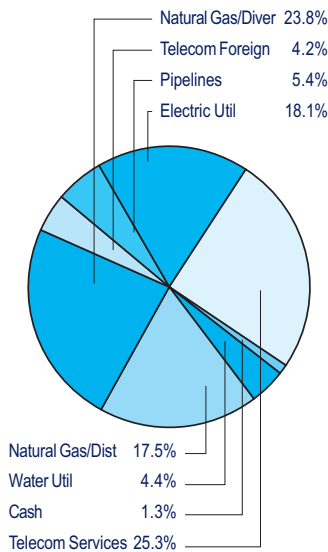
Quarter Composite Net of Fees*

BTB/Util (Preliminary)	-0.35%
DJUA (total return)*	-4.96%
LBGC*	0.54%
Ave Util Fund	-3.26%

12 Month Composite Net of Fees*

BTB/Util (Preliminary)	17.18%
DJUA (total return)*	0.87%
LBGC*	-1.62%
Ave Util Fund	14.68%

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



funds, balanced funds, high-yield bond funds, and the average of all equity mutual funds. Better, in fact, than virtually every category save large-cap growth and S&P500 index funds. Naturally, these kinds of comparisons may not always hold true, as markets change, but this has been the state of affairs for quite some time, and we believe most observers would not have expected us to do as well as we have. In fact, one institutional consultant recently said he didn't want to meet with us, because, as he put it, "you can't make any money in utilities." John Templeton once said to us, "I thought I could make more money elsewhere." Yet our returns over five years—which is not forever but is still a pretty long time—have outperformed both of them.

Actually, most investors might be surprised to know where utilities stand relative to other sectors over the past 25 years, starting in 1974 (which is arguably the beginning of this bull market). According to Wilshire Associates, here is the ranking by sector for both the 500 largest and 2500 largest US stocks, along with their returns:

SECTOR	500 LARGEST US STOCKS	2500 LARGEST US STOCKS
Consumer Non-Durables	15.52	16.74
Utilities	15.09	16.01
Cap Goods	14.57	14.19
Financials	14.51	14.98
Cons Durables	14.25	14.75
Technology	13.67	14.58
Energy	12.82	13.58
Transportation	11.50	13.22
Materials	10.44	11.60

(25-Year Returns Courtesy of Wilshire Associates)

Two items are of interest to us. First, returns for all sectors over the 25 years are improved by the addition of smaller stocks (except Cap. Goods, a sector that GE dominates). Does this sound like the past three years? Not really, but things change, even when it seems they never will. *Second, over the past 25 years utilities have been the second best performing sector in the market, for*

both large stocks and the broad market; indeed, they noticeably outperformed the S&P 500, which returned 14.88% for the period (The Wilshire 500 returned a similar 14.76%).

The question this brings to mind is obvious: these results are surprising, and why should the outstanding performance of utilities be such a surprise for most investors? The answer isn't so obvious, and we don't think we have it. Perhaps it has something to do with the speculative nature of individuals who become involved in investing. The speculative mind imagines great gains, and its imagination is fired by the occasional large winners that tend to appear more often in the non-utility stocks. Scholars of Behavioral Finance have determined that investors are overoptimistic and have a higher opinion of their ability to predict the future than is warranted by the facts. To that we might add that in the constant decisional tension between *certainty* of return and imagined *potential for maximum* return, investors undervalue certainty. And do so to their detriment.

PORTFOLIO HIGHLIGHTS

Gas was the biggest fuel for our returns this quarter. As you know, gas plays a major role in our portfolio, since it is the energy source of the future and is experiencing much stronger usage growth than electricity (gas is also the beneficiary of electric deregulation, since nearly all the new plants that have sprung forth as a result of deregulation are gas fired). Indeed, in many areas growth is as strong as for telecommunications, but with greater certainty, less competition, and investable at much more modest multiples of earnings and book value. We bought KN Energy when it's earlier deal fell apart and fleeing arbitrageurs knocked the price down to somewhat absurd levels. Within weeks Kinder Morgan, Inc (the general partner of Kinder Morgan Energy Partners, which we also hold) created a deal with KN which essentially puts Richard Kinder, a premier manager in the energy field, in control. Our 40+% gain in this situation looks rather fine against the market backdrop for the quarter. We were also helped by gains in El Paso Energy and takeover target Sonat, a strengthening in Keyspan, and stable to positive performances in stocks like Sprint, Century Telecom, Wicor,

UTILITIES PORTFOLIO CHARACTERISTICS

Beta*	0.61
Dividend Payout	61%
Sharpe Ratio*	1.15
Projected Dividend Growth	4.2%
Treynor Ratio*	19.49
Current Yield	3.7%
Annualized STD	10.36
Market Cap (MDN)	\$3.9Bil
Price/Book	2.40
Quality	B++
P/E Ratio (MDN)	16.94

*Relative to DJUA, 9/30/94-9/30/99

LGE, and GTE. Frontier's takeover by Global Crossing finally transpired, but perspired is more like it, as Global's stock price woozed up and down through the quarter, putting the deal in doubt at times, and Frontier's followed suit. When the dust settled we received a stock-equivalent \$53 – not as high as hoped or initially “promised,” but not bad for a stock we first purchased a few years ago at around 17. Although the opaque present nature of fiber optic usage pricing makes Global hard to value, the acquiring stock has been so beaten down that risk seems minimized, and the combined company is a conceivable takeover target now as well. So we're holding, at least tentatively.

On the downside, our portfolio progress was limited by slow going on the electric side, which responded to a poor quarter for the large-cap electrics that drive the major utility indices. NiSource, Cinergy, Utilicorp, and New Century, all posted losses in the teens, though there were no particular negative fundamental developments (both Cinergy and New Century exited the energy marketing business, which is a positive, if anything). Some phones such as SBC were a drag, as was Williams, a stock that typically assists our positive alpha.

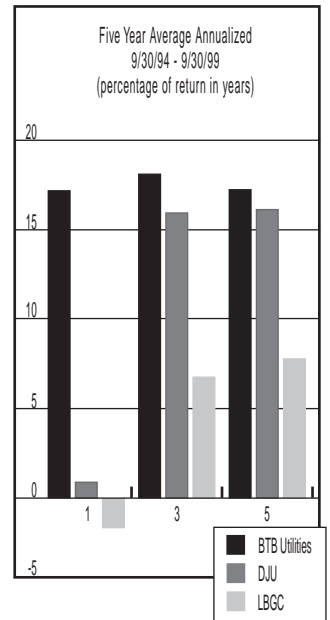
While we thought the portfolio might do better this past quarter, all in all performance was quite satisfactory considering the market environment. We made very few changes, apart from adding some Worldcom, a position that has not yet helped the portfolio.

LOOKING FORWARD

Looking forward, we continue to think that the values and certainty of cash flow in our portfolio will support its competitiveness against other securities, and the safe-haven quality of utilities may well garner a surprising degree of support as the century winds down. We have evaluated our stocks for Y2K preparedness, and do not feel there will be problems of any significance. Importantly, there is minimal foreign exposure in the portfolio—we believe foreign stocks are the potential hot spot for millennial difficulties. Bonds continue to be overvalued relative to inflation rates, and bonds could do well if there are signs of slowing in the economy. While in recent years a disconnect has

developed between bonds and our stocks, falling interest rates are hardly likely to hurt our position.

We also hold many stocks with high promise that have recently traded quite dully. More phones may join our Sprint, which has just become the object of heated bidding. Our utilities with energy exposure have not yet been discovered by investors during this up cycle for energy prices, but that is merely a matter of time. And takeovers of our smaller distribution companies are an ever-present possibility. Indeed, as we write, our major holding MCN has received a premium offer from DTE Energy. We'll be making some changes this quarter (we do hold stocks with deals pending, or deals completed resulting in shifted weights in our portfolio) but we continue to find the remaining stocks in our portfolio pendant with potential. Bearing in mind the inevitable uncertainty regarding the impact of Y2K, we continue to find this an attractive period for our utility stocks. □



DISTRIBUTION PORTFOLIO

Most investors are aware by now that there is tremendous consolidation activity going on in all sectors of the utility industry. As you know, we have had numerous transactions in our BTB/Utilities portfolio this year, which have provided a nice boost to returns. Yet there is a world of stocks out there which we perceive as takeover candidates whose prices do not appear to reflect takeover speculation: we have no trouble finding stocks with 50% or greater potential appreciation based on the established private market value for similar companies. Why this potential should “just sit there” is something of a question. It would appear that most sophisticated arbitrageurs and buyout speculators are more interested in larger deals.

In any event, at the end of last year we initiated a portfolio composed exclusively of smaller distribution companies (in all sectors, though mainly in gas at the moment) most likely to be taken over in the convergence/consolidation era. SBC or AT&T doesn't show up in this portfolio, but Frontier did. Enron won't be represented, but we've had takeovers this year in Connecticut Energy, CTG, and Yankee Energy. American Water might show up, but we did hold United Water, a recent acquisition, and, of course, MCN. Returns have been held back just a bit by a very soft first quarter to utilities generally (this was before the action in smaller companies really got going), but are still up nicely year-to-date with a gain of 9.63% (gross) as of September 30 and another 4% or so in the first two weeks of October. Accounts that began at the end of the 1st quarter are now up roughly 25%.

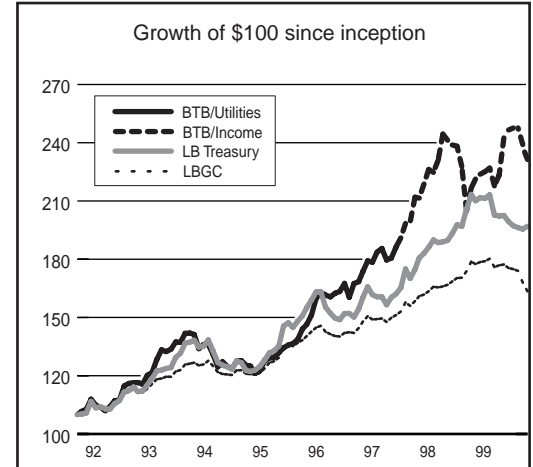
We haven't promoted this portfolio heavily since it does have a limited lifespan—eventually there will be no more corn to pop. But for as long as the industry is in a consolidation phase we find more upside potential than in the broad market, and considerably less risk. Even if some stocks don't get taken over they will still be reasonable utility holdings, and the portfolio offers a current yield of over 4%. If you'd like to know more about this low-risk, high potential concept, which we are almost uniquely qualified to exploit, give a call to Helen Hamada at our office (914-679-9166).

“...the stocks we hold are cheap when viewed as real businesses, and sooner or later that value must surface.”

The usual question of whether our BTB/Income portfolio is more affected by conditions in the equity markets or by the interest rate environment was not difficult to parse this past quarter. Poor conditions in the equity markets were a drag on performance, as nearly everything in sight declined, particularly value-oriented stocks. Though overall performance wasn't too bad considering market conditions as well as the fine year-to-date performance—we remain far ahead of our benchmarks—we were still disappointed that the portfolio did not present a better profile. The quarter appears to have ended on an odd data point for this portfolio, however, as most of the stocks have bounced and most of the shortfall from last quarter has been made up in the opening days of the 4th quarter.

PORTFOLIO HIGHLIGHTS

Our interest in gas distribution was well rewarded over the summer, and it was one of those times when we wish we “wouldda” carried even more weight in gas, as the net returns from this group were solidly positive—a statement that can be otherwise made only about selected technology issues. The highlight of the quarter was clearly our position in KN Energy convertible preferreds, which rose 41% over the period and *still* yield about 9%. Sonat rose as its acquirer (El Paso Energy) found new friends on Wall Street, and at last in part to its exposure to energy prices. Kinder Morgan also rose on news that its general partner would, in effect, be taking over KN (here acquirer and acquiree both gained). Eastern Enterprises and Keyspan, both held with a view toward potential acquisition by larger players helped the portfolio as well. Not every gas stock showed price gains, but we believe our thesis is still intact: though MCN lost ground for the quarter, in the first week of October the company received a buyout bid from DTE Energy and is



now up about 50% since September's close. We continue to think that gas distribution is a fertile area, and will mine this vein until it is played out.

Although many of our more broad-market stocks have improved in pricing as the quarter has begun, they were definitely the culprits during the summer period. J.C. Penney made us look smart in the second quarter, then foolish in the third. In our view the market is once again undervaluing these assets, but the overall pricing for drugstores has softened somewhat the premise of undervaluation regarding Penney's drug division. Core apparel sales continue anemic compared to some retailers, though in general the retail sector has shown poor fundamental as well as poor price performance in recent months. But we think JCP is rolling out some interesting retail themes now, and the drug division is still an occult element of the stock price in an industry that has clear consolidation activity. So we continue to hold, especially for the purposes of this portfolio, with a 5+% yield that appears safe for now.

Similarly, Armstrong World posted a sharp decline despite a housing market that is among the best this country has ever seen. This is by now a Rodney Dangerfield company that “can't get no respect” among investors, even provoking a “short” advisory in a business

Quarter Composite Net of Fees*

BTB/Income(Preliminary)	-6.55%
LBGC	0.54%
LB Long Treasury Index*	-0.14%

12 Mo Composite Net of Fees*

BTB/Income	6.78%
LBGC	-1.62%
LB Long Treasury Index*	-7.68%

*See Performance Disclosure on back page. Index returns are stated gross of fees, although it is not possible for an investor to purchase the index without incurring fees.

magazine despite the fact that it sells at a lowly PE of 9. We would be willing to part with the stock if earnings don't materialize as expected; but if they do, this one appears to be one of the biggest bargains around, and we'll just have to tolerate some ignominious quarters.

Union Planters added a performance drag as banks were weak across the board, though the stock held quite firm in the low 40's and in fact outperformed nearly every other bank stock. It's one of the highest yielding issues in banking, and its relative performance this quarter prompts us to think that better things are in store. Timken was also soft, but has also bounced in the early days of October. The company is restructuring, and should be ready and lean as the world's smokestack economies begin to recover in the coming quarters. Management is proven and conservative here, and it's business niche is secure; we expect a return to the higher prices seen earlier this year sooner rather than later.

We got snookered by management at Ogden, and the result represented fully one-third of our loss. We had been holding the stock in anticipation of an announced split-up of the company's energy and service divisions into two companies. Then, in August, the company dropped a bombshell with no warning: the service company wasn't big enough to stand on its own and would be sold, the energy company would continue alone, with no dividend. This is actually the first time we've experienced a dividend elimination in either of our BTB portfolios over the near-decade we've been managing income stocks. We suppose it had to come sometime, despite the vigilance we try to maintain. That shoe has now dropped. We had been awaiting a bounce which doesn't appear to be forthcoming, so we'll shortly be picking up our marbles and going home.

Frontier was a breathtaking roller-coaster of a ride in a position that we increased to take advantage of a seemingly docile short-term arbitrage. Our Frontier stock

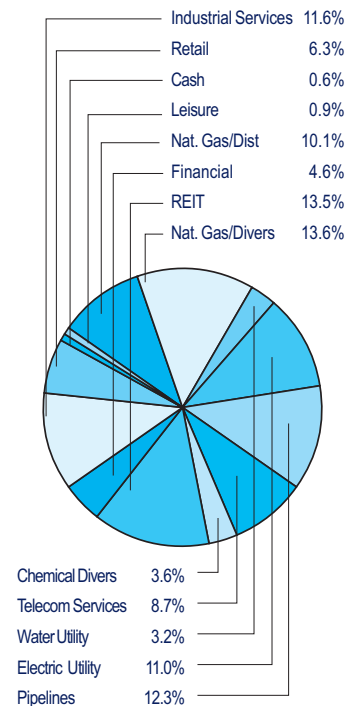
rocked and rolled with the declining fortunes of Global Crossing, finally closing at near breakeven on the arbitrage, though a substantial profit on our original shares. But the telecom world is like a lightning field now, and no sooner did the deal close than Global/Frontier began to be discussed as a possible buyout candidate itself. So, as we write, our converted stock is now far higher than the original deal proposed, and the final chapter has yet to be told...

We added E'Town, a water company from New Jersey, that presents essentially the same financial picture as the recently taken-over United Water. Indeed, we're hard pressed to know why the stock didn't jump on the United Water news. The deals in small water and gas companies appear to be *too small* to interest the major arbitrageurs, since, unlike most other industries, takeovers don't seem to move similar stocks. But they're not too small for us, and we'll keep adding more of the same.

LOOKING FORWARD

We have a few items to clean out of the portfolio this quarter, and a few of the above types to add. Overall, we doubt the frustrating experience of the 3rd quarter will be repeated: Y2K or no, the stocks we hold are cheap when viewed as real businesses, and sooner or later that value must surface. In the meantime, many of our issues have recently raised their dividends, our yield is higher than long-term bonds, and our growth potential is untrammelled.

Current income plus growth is the primary objective of BTB/Income. As of September 30th the current yield on this portfolio was 6.4%, with a projected growth of yield at 4%, and projected earnings growth of 9.9%. □



FUNDAMENTAL CHARACTERISTICS

Yield	6.40%
Proj Div Gro	4.00%
Payout Ratio	68%
Market Cap (MDN)	\$1.6 Bil
Price/Book	2.16
Beta*	1.06
P/E Ratio** (MDN)	13.14
Quality	B+

*Relative to LBGC, 9/30/98-9/30/99
 **Reit's use P/FFO ratio rather than P/E Ratio

“...stocks with solid fundamentals can often be ignored for long periods, and then suddenly burst upward through a vacuum of sellers just when investors seem most apathetic.”

Bad things happened to good stocks this past quarter, and the SBI portfolio struggled. While it would have been difficult if not impossible to post happy returns over the period, since quality stocks of all stripes found an absence of buyers, we also experienced some torpedoes that were unique to our portfolio. It was as if all the bad news was saved up for us, like mail that piles up after an extended business trip. The core of our stocks were no worse than the run of the mill, but special situations brought us down somewhat below par. The good news is that our portfolio has come back strongly in the beginning of the fourth quarter.

PORTFOLIO HIGHLIGHTS

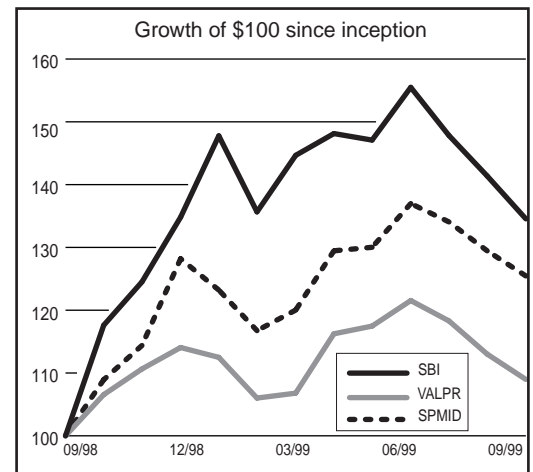
In a quarter with declines so lopsidedly outnumbering advances across the board there were still some bright spots. We aggressively moved into KN Energy after a broken deal early in the quarter, and a new deal with Kinder Morgan, Inc. provided a profit approaching 50%. (Read more about this deal in the *BTB/U Portfolio Highlights*.) By nature this portfolio has been lightly weighted in technology, but we did get some help from two stocks that had been problematic earlier in the year, Computer Associates and Network Associates, both posting double-digit gains. IBM showed a small loss and two large drugs, Warner Lambert and Baxter finished the quarter with nominal losses.

But many of our solid stocks, which weren't overvalued to begin with, shed some points over the period. Fannie Mae and SLM Holdings (Sallie Mae) were affected by morose credit markets, though not radically so. Defensive issues like Ralston and Heinz didn't look so defensive with losses in the teens, already cheap S&L leadership stock Washington Mutual shed nearly 18%, and even our long-term favorite Williams was down by double digits.

Still, the portfolio had enough pockets of strength to achieve a more acceptable return, were it not for a handful of situations that really dragged down performance. The turnaround at Xerox appears somewhat aborted at this point: the company is experiencing weak sales and a management restructuring that hasn't gone as well as planned. Alza, which is going to be taken over by Abbott Labs suffered when Abbott announced a conflict with the FDA over some test product manufacturing facilities (that AZA recovered all of its loss in the first seven trading days of the 4th quarter is worth noting). Rambus, a special situation stock, suffered when Intel announced that they had not worked out all the bugs on a board designed to hold Rambus chips. Intel is working on the problem, but in the meantime Rambus' position became shakier and so did the stock. We decided to exit and return when the

Quarter Composite Net of Fees*	
SBI	-13.46%
S&P 400Midcap	-8.40%
Value Line Index	-10.33%
12 Month Composite Net of Fees*	
SBI	34.56%
S&P 400 Mid-cap	25.49%
Value Line Index	8.98%

*See Performance Disclosure on back page



picture was clearer. Early in the quarter special situation Closure Medical reported much softer than expected sales, and became a speculation that didn't work. MCN cost the portfolio substantially, but has become a takeover target in the opening days of the new quarter and is up some 50% from its September close. Despite good earnings results and a raging housing market Armstrong World

can't seem to find buyers, even at a PE of 9—this is the kind of situation that finds a corporate buyer when public stock investors don't "get it."

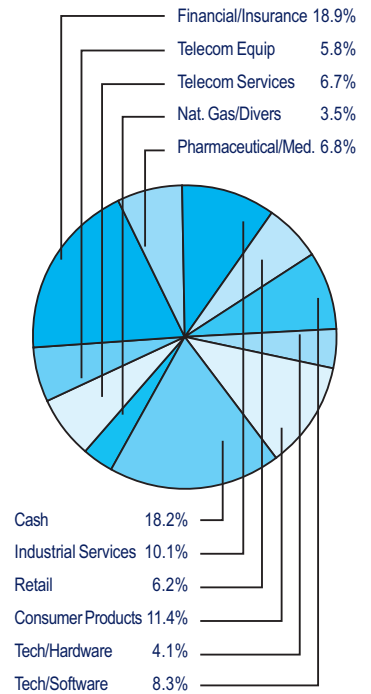
Equity management is passive to a rather great extent, and we can no more control the dumping of a great name like Washington Mutual than we can the slightly lunatic buying in the internet area. But we might have avoided some damage in Rite Aid by being a little less patient and a little less forgiving. One of our investing principles is to look elsewhere when the credibility of management is in question. There were a number of occasions this year when we might have reasonably come to the conclusion that Rite Aid management was either lacking in competence or forthrightness, but in retrospect we find that we were lulled into complacency by the low valuations and strong same-store sales comparisons in the industry.

LOOKING FORWARD

In general, an evaluation of recent quarters yields two important insights: our overall long-term orientation has kept us involved in certain stocks too long when macro trends have been antagonistic, and, at the same time, an excessive concern with tax efficiency has restricted our profit-seeking activity. Portfolios can be quite tax efficient when losses are matched against gains—even when turnover is higher—and we intend to return to our earlier approach of selling or trimming positions on price spikes. On the other side of the coin, we will be more active in eliminating positions where the fundamentals are taking longer to develop favorably than we had anticipated when entering the position. Too, our firm's technical skills are strong, and though our stock selections are basically fundamental in nature, there is certainly room to add value through more technically influenced buy and sell decisions. In recent years the market has moved quickly, and has revealed much

more rapid sector rotation than was true in the past. Our long-term nature needs to better accommodate market conditions, taking profits when they are available, retreating when risk becomes more palpable, becoming more willing to come back to a situation later if our initial position lacks timeliness from either a fundamental, technical or macro-factor standpoint. So there will likely be more activity in this portfolio going forward, and we believe that acceptable tax efficiency will still be maintained.

As we noted just before the second quarter's nice rally, stocks with solid fundamentals can often be ignored for long periods, and then suddenly burst upward through a vacuum of sellers just when investors seem most apathetic. We thought the second quarter was the beginning of a longer-term renewal in value-oriented stocks. Perhaps it was a false start, or perhaps it was a new beginning that's simply been slower than we'd like in building momentum. Whatever the case, most of our stocks sell at prices well below their private market values. Though Y2K may intervene for a short while, businesses selling at a steep discount don't stay there for very long. The "on sale" signs we find in many of our stocks as well as throughout the entire "non-technology" market will be coming down before long. Down the road, investors will be wondering how so many could have gotten so cheap all at the same time... □



FUNDAMENTAL CHARACTERISTICS

Yield	2.5%
Proj Div Gro	9.39%
Payout Ratio	32%
Market Cap (MDN)	\$9 Bil
Price/Book	5.11
P/E Ratio (MDN)	16.11
Quality	B++
Beta*	0.90
STD	25.12
Sharpe Ratio*	1.19
Treynor Ratio*	33.09

*Relative to S&P 400 Midcap Index (9/30/98-9/30/99)

DOES UNDERVALUATION EXIST?

"If there's one universal constant in the market, it's the claim of money managers and brokers that they seek only "undervalued" stocks. I've never heard a manager or broker proclaim that their favorite stocks were overvalued, or even fairly valued. There's certainly nothing wrong with seeking bargains and trying to follow the old maxim of "buying low," but all these claims seem to me disingenuous at best. Perhaps we're merely dealing with an insensitivity to language or an excessive use of jargon. But how all these would-be's whose portfolios consistently underperform the averages could claim to buy only undervalued stocks is beyond me.

The quest for so-called "undervalued" stocks is a tricky one, resting upon a questionable premise. What would lead an average individual investor to believe—for that matter what would lead a professional investor with a team of assistants to believe—that the investor can recognize an "undervalued" stock whereas all the rest of the world, all the trillions of dollars of brain and computing power, all the armies of researchers and global profit-seekers, cannot? When you think about it, the view that a particular stock is undervalued can only be seen as sheer arrogance. (Recall that one of the insights from Behavioral Finance is that investors consistently overestimate their abilities and prescience.)

This notion that a stock is "undervalued" flies in the face of any notion of market efficiency, and it certainly flies in the face of the fact that today, more than ever before, all relevant information about a company is instantly available to any investor in the world via electronic communication. You're not alone with your information today. No investor is. All the information you can legally use is at your fingertips on the web, and in the numerous business publications and media which are pumping out the facts as fast their reporters can speak or pen the words. This is not just available to big-time fund managers. *No one knows more than anyone else* at this point, save company management.

The price of a stock today, then, depends upon investor opinion (do investors want these shares now, or are they apathetic?) of facts that have been exposed for all to see. If twelve brokerage firms cover a company, three may have "strong buy" ratings, three may have "neutral" ratings (only about 1.5% of stocks ever carry a "sell" ranking), and six may have ratings somewhere in between. The world of the actual market of buyers and sellers is the same. Investors come to different opinions based on the same set of facts, and the weight of their decisions is what determines the price of a stock (within some unspoken maximum and minimum boundary band which delimits the impossibly

outrageous limits of pricing). The price of any stock today is a quantified opinion, quantified as a number, a price.

"Undervaluation," is really, consciously or unconsciously, a code word. What's really meant is the belief:

1) that the company will do better in the future and investors will recognize this through a willingness to pay higher prices in the future for those still-to-come improvements, or

2) that investors are being overly emotional about a company's problems or changes, and over time investors will come to see the errors of their ways, come to see that the company has more power as a business than they'd given it credit for and are currently willing to pay for it.

But both these possible beliefs are only beliefs, the truth of which will only be known when times has passed. In either case the important view is that the company will do better, not worse, in the future, and the stock price will follow. (Even pure asset value investors don't get interested if they think a company is going to do worse and worse.) Well, that's not really analysis; it's more a kind of attitude, a kind of common sense. I use it myself. I say, "Companies that have done well in the past are likely to do well in the future. Let me try to buy them at a reasonable price, since no one's going to let me walk off with them on the cheap."

True, there are rare moments when investors toss away a perfectly good company for not-so-good reasons, but most of the time there aren't many if any real bargains available. Other investors are smart too: the true bargains get snapped up as quickly as they are found. Many years ago I worked in the real estate business in Manhattan. When I came across a naive seller offering a property below market, do you think I offered this property to clients of the firm? Of course not! I arranged to buy it myself!

But the quest for undervaluation isn't the real quest for long-term investors. (Even a fairly-valued stock should be acceptable if it is going to deliver the kinds of dividend-growth performance we seek.) The price of a stock next year, and its price gains or losses, doesn't just depend on "under" or "over" valuation today. It also represents what has happened to the world and to the company in the space of time between today and next year. There's a kind of narrative involved, the real-life true adventures of a company as it progresses through time, its pratfalls and successes, its agony of defeat, its thrill of victory.

The inarticulate, hidden meaning of "undervalued" is that a stock has a proposed story, and the believer in undervaluation believes that the story will come true. As in the movies, there's not just one story. There are millions of stories, each one a little different, each with different characters and plot twists.

It might be as simple as: *I believe this stock will grow its earnings 10% next year, and in that case the stock will be 10% higher, plus I'll get my dividend.* Or it might be more complex: *this company is in the process of selling off a division that never earned them any money. They're going to show larger-than-expected profits, and they'll do a stock buy-back with the proceeds!* Or it might be the dream of a Great Tailwind: *oil prices are going to go through the roof next year; this drilling company will be the biggest beneficiary.*

Whatever the story, it's always about the future, and the future is always, ultimately unknowable. There are only probabilities. And there are factors, influences. What will interest rates be a year from now? What will inflation be? Can this company's story come true if interest rates rise? If the dollar gets very weak? The factors proliferate, and the more they proliferate the more complex and variable the "story" becomes.

So to invest you must turn away from ideas of "undervaluation," since they are really mute notions, incomplete and inadequate expressions of the story of the stock. No stock is undervalued today, for today it is "worth" what investors are willing to pay for it, no more and no less. Will it be worth more tomorrow, a year from now, ten years from now? That depends on whether or not its story comes true. The real questions then, are only two: how likely is the story to come true? and how much is the stock likely to sell for if it does?

THE STORY OF THE STOCK

You won't hear professional investors talking about this, nor has there been any academic study done, but I believe that in the end investors make their buying decisions more or less holistically, looking at the whole picture of a company, the whole story. Most investors screen, either overtly with software programs or unconsciously through their operative biases, for a general type of stock they're looking for. Then they add up the features of each, trying to discern the overall picture. It's not so different from buying a house—you might look at two dozen homes, tallying up the features of each and the problems of each, finding comparisons that are easy to make and finding comparisons that are hard to make because each house is different, holding pictures of each in your mind's eye, picturing yourself reading the Sunday paper over coffee in each, finally deciding on just that one single dreamhouse versus the others—for reasons you're not totally sure of. It's something about the whole deal...it *feels* right..

With stocks, the situation is just a hair less emotional, and we can separate out for analysis some of the pieces that make up the whole picture. There is, of course, in a Single Best Investment stock, the triple requirement of high quality, high yield, and high projected growth of yield—something like requiring five bedrooms, five baths, and a good location in that perfect home. And there are

value measures, most of which tend to fall into place if a company meets the triple formula, such as low price/sales, low PE, low price/book, low price/cashflow, rising cash assets—the equivalents of eat-in kitchen, deluxe master bath, multiple fireplaces, pool, and cabana house.

BARGAINS

I've already made clear, I think, my view of the concept of undervaluation. A stock is always priced at its correct value today, for how can a stock have a value other than what investors are willing to buy and sell it for? But that statement does *include* situations where investors have become emotional about a stock, or even apathetic about a stock. The story of the stock, in effect, becomes the fact that, in the eyes of an investor, *other* investors are viewing the stock irrationally. Obviously, differing opinions are what makes a market, but in this case you must be convinced that there is palpable and extreme emotionalism attached to the price of the stock. One good case in which this appears with some regularity is when stocks perceived as growth items come in with disappointing earnings. If the number's bad enough, growth investors dump the shares at any price, sometimes chopping 50% or more off a stock in a single day or week. Here we might find, in a particular situation, that while the stock has failed for now as a growth-stock vehicle, at current prices it might be a value prize. The emotionalism of individual investors and fund managers can create a temporary window of opportunity, when all the other factors are "right."

But don't go using the "U" word. Just operate on the provisional hypothesis that the selling is excessive and due to secular factors in the market that will reverse rather than the fundamentals of the company. Do you remember when the Three Mile Island nuclear reactor had a problem and had to shut down? Investors also shut down the holding company's stock, although General Public Utilities was a major mid-Atlantic utility with a long operating history and many other fine assets. The stock crashed like the market in 1929. And went on to become one of the best-performing investments in the world over the next ten years.

In the normal course of events, there is no undervaluation, there are only stories which may or may not come true. For us, a good story means finding solid companies with good yields whose long-term prospects feature *moderate reliable growth*, growth which will be sufficient to boost the dividend, steadily increasing our current income and thereby creating upward pressure on the price of the stock. It's a boring story, but it works."

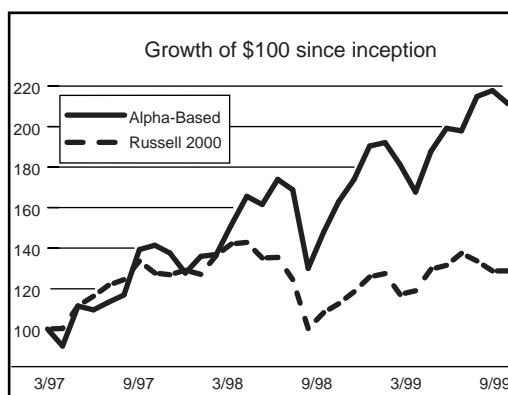
*The previous two pages have been excerpted from Lowell Miller's book **The Single Best Investment**, available in bookstores or online. For bulk purchases please contact Marilyn Marecek at*

For the second consecutive year, summer was a bad season for equity investors as all major averages suffered significant third-quarter declines. But the summer of '99 was a picnic compared to the summer of '98 when the Russell 2000 tumbled 20%. This year, the small-cap index declined a more moderate 6.24%, about in line with the drop by other market averages.

The Alpha-Based Strategy experienced excellent relative results this quarter. It was the sixth quarter of the last seven in which we outperformed the Russell 2000. Our composite of accounts produced a gain of 6.79%, net of fees. That's an advantage of 13% over our benchmark. An advantage of that size for a quarter is gratifying in any circumstances, but it's especially notable when the broad market averages are down.

Most of the stocks in the portfolio have betas greater than 1.0. Most consultants and academicians of portfolio management theory would concur that, other things being equal, these stocks ought to decline more than the market averages in a down market and advance more than the averages in a rising market. Well, the Alpha-Based Strategy disproved this theory once again. However, a theory that remains confirmed by our performance this quarter (and past quarters) is that there are many ways to define and measure risk. And that a beta greater than the market combined with a high alpha can provide strong performance in a weak market. We were able to post positive returns while the broader market declined due to our disciplined portfolio process. Portfolio positions are backed by high alphas, (which measure the tendency of stocks to move independent of the market's direction) and by exceptional fundamental growth and value.

This quarter's gain moves us solidly ahead of our benchmark year-to-date, and well on our way to the third consecutive year in which we have beaten the index since inception of the Alpha-Based Strategy (early 1997). Our year-to-date gain in Alpha is 11.09% net of



fees versus 2.46% for the Russell 2000.

For the past twelve months, the Alpha-Based composite has gained 42.98% after fees compared to a 19.07% advance by the Russell 2000 (gross of fees). Since inception, there hasn't yet been a twelve-month period in which our Alpha-Based approach has failed to beat the small-cap benchmark by a solid margin. In part this is due to strategic use of cash which helped contain losses during the worst weeks of the quarter. Part of our success has been due to agile trading. For example, stocks were sold heavily near the market's mid-July peak, raising the average cash level to more than 25%. Most of that cash was put to work in early August in time to catch a short-lived rally. By mid-September when the market resumed its swoon, cash was pushed back up to the vicinity of 25%.

PORTFOLIO HIGHLIGHTS

Concord Camera contributed heavily to our success, as it has done so often since we first began buying LENS near the 2 price level. One of our largest positions three months ago, it gained 65% during the quarter, aided by a bullish earnings report and forecast. We took partial profits along the way and *still* see reasonable prospects for this stock to double during the next year or so.

Monterey Pasta, our largest position at the start of

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

Quarter Composite Net of Fees*

Alpha-Based	6.78%
Russell 2000	-6.32%

12 Month Composite Net of Fees*

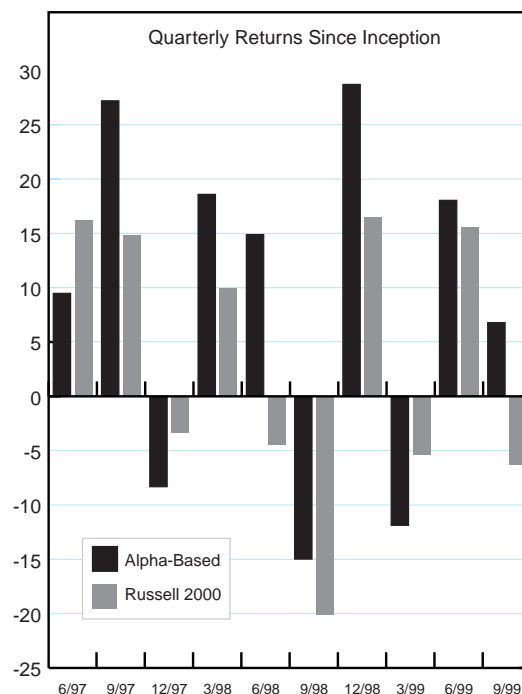
Alpha-Based	42.98%
Russell 2000	19.07%

*See Performance Disclosure on back page

We sold Audiovox during the quarter for a gain of almost 80% from our May purchase price. We took trading profits of more than 40% in Gentner Communications, and almost 40% in Chico's FAS, an old favorite that was revisited during the quarter for a very rewarding trade.

We took a substantial position in Take-Two Interactive Software during the quarter and were able to take partial profits of some 30% soon thereafter. TTWO closed the period 40% above our purchase price and continues to offer excellent potential.

These successes more than offset major disappointments in Javelin Systems and INTERLINQ Software. The latter was sold for a substantial loss when management reported that near-term results will be very disappointing. JVLN remains a favorite for its exceptional long-term potential, though we may be trimming our involvement here on rallies.



FUNDAMENTAL CHARACTERISTICS

P/E Ratio (MDN)	12.56
Market Cap (MDN)	\$93 Mil
Price/Book	2.69
LT Debt Ratio	38.87
Beta*	0.96
R-SQR*	0.53
Annualized STD	28.14
Alpha*	27.41

*Relative to the R2000, 9/30/97-9/30/99

LOOKING FORWARD

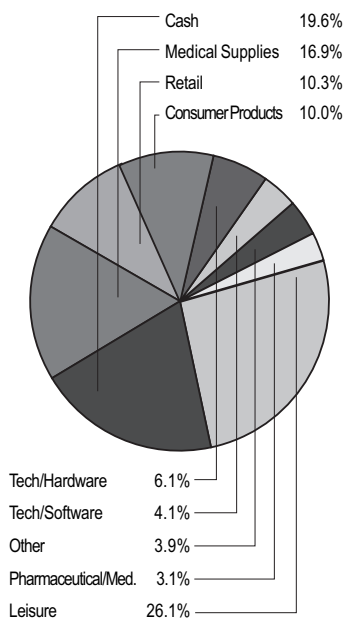
The market is quite "oversold" at this time. The general outlook for small-cap stocks and for the stocks we hold in particular is positive looking out over the next several quarters and years. However, in the short-term we've been awaiting solid technical buy signals from the stocks we are interested in acquiring before adding new positions to the portfolio. We found that substantial cash positions in this market have not hindered our returns, and provide "dry powder" for opportunities that arise.

If the past is a guide, we should expect to score good gains between mid-October and mid-November when most of the companies we hold will be reporting sales and earnings for the third quarter. If such rallies carry our stocks to the upper end of their trading channels, we'll likely take some profits once again, since the market may remain fragile until after the New Year.

This pattern of buying favorite stocks when they trade in the lower part of their trading channels and selling them when good news pushes them to the upper end of such channels has been working quite well. In a world of fully valued blue-chip stocks and worries about Y2K issues, it appears that the best way to address longer-term risks is to be highly attentive to short-term risk.

Alpha-Based doesn't really have a Y2K strategy other than to let the market and our stocks drive our actions. In the best possible scenario, the undervalued stocks we hold would ride bullish earnings reports to the upper end of their trading channels during the next six weeks, pushing us even more heavily into cash toward year end.

Eventually, small-cap stocks will enjoy a period of rising relative strength and we will have the satisfaction of working with the wind at our back instead of blowing briskly into our face. When that time comes, we fully expect the deeply undervalued growth stocks we hold to



Disclosure: Gross of fees performance is calculated according to standards set forth by the Association for Investment Management and Research (AIMR). Net of fees performance is based on actual results after the deduction of management fees (weighted average fee of 200 basis points). Included in the results are all Alpha-Based portfolios that are unrestricted, including one non-fee paying portfolio, and that have been managed for at least one full quarter. In addition, in order to be included in the composite a new account has to be at least 80% invested and it should hold not more than 5% cash exceeding the maximum cash held by any portfolio already in the composite, as of the end of preceding quarter. The number of accounts in the composite as of 9/30/99 was 26, which represent 49% of total assets managed in this strategy with a measure of dispersion of 1.55. Miller/Howard Investments has prepared all performance results. AIMR was not involved in the preparation or reporting of these results. A complete list of all the firm's composites is available. Portfolios are typically fully invested, and hold minimal cash although cash holdings may fluctuate somewhat on a residual or transitional basis. Inception of the composite was 3/31/97. No representation is made that future returns will approximate past results, and none should be implied.

Net of Fees Performance Disclosure

Yield-Oriented Portfolios: Gross of fees performance is based on actual results according to standards set forth by the Association for Investment Management and Research (AIMR). Miller/Howard Investments has prepared all performance results. AIMR was not involved in the preparation or reporting of these results. Net of fees performance is calculated by deducting a weighted average annual fee of 75 basis points from gross of fees performance. A complete list of all the firm's composites is available. Portfolios are matched across all accounts so that each client holds substantially the same issues at the same weights. Portfolios are typically fully invested, and hold minimal cash although cash holdings may fluctuate somewhat on a residual or transitional basis. No representation is made that future returns will approximate past results, and none should be implied.

Better Than Bonds/Utilities: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 9/30/99 was 110, which represents 46% of total assets managed in this strategy with a measure of dispersion of 0.18. Inception of the composite was 9/30/91. (Note: The composite represents only 46% of assets managed in this strategy because two large clients, a mutual fund and a pooled fund, are not included due to excessive and non-regular cash flows.)

Better Than Bonds/Income: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 9/30/99 was 14, which represents 61% of total assets managed in this strategy with a measure of dispersion of 0.71. The cumulative chart contains a combination of Better Than Bonds/Utilities performance from 9/30/91 through 9/30/97 and Better Than Bonds/Income performance from 9/30/97 through 9/30/99. Better Than Bonds/Income as a stand alone strategy started in May of 1997. BTB/Income is a strategy that evolved from BTB/Utilities sharing the same philosophy and process and many of the same stocks. The essential difference between the two is that a portion of BTB/Utilities invests in Telecom stocks and a comparable portion of BTB/Income invests across the broad market.

SBI: Included in the results are all portfolios, including one non-fee paying portfolio, that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 9/30/99 was 8, which represents 81% of total assets managed in this strategy with a measure of dispersion of .39. Inception of the SBI composite was 9/30/98.

Benchmarks: The benchmark data from which this report is prepared has been provided by sources generally considered reliable. Except for benchmark returns based on published mutual fund net asset values, and unless otherwise stated, the index performance figures contained in this report do not reflect the deduction of investment advisory fees. Mutual fund data published by Lipper are net results after deductions of all annual fees and expenses by the advisor. Benchmark returns are presented on a total return basis unless otherwise stated.

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