Miller/Howard INVESTMENTS, INC

MARKET OVERVIEW

THE STRATEGIES

BETTER THAN BONDS / INCOME

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

BETTER THAN BONDS / UTILITIES

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

DISTRIBUTION / EMERGING UTILITIES

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

THE SBI PORTFOLIO

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

ALPHA-BASED STRATEGY

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

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Our society and our economy, and by inference our markets and the investors who participate in them, have apparently finally succumbed to Gresham's Law. Gresham's formulation, which was probably first stated in fact by Aristophanes some 2,400 years earlier, is quite simple: bad money drives out good.

Gresham was a wealthy merchant in England when King Henry VIII went to war against Francis I of France in 1544. The King leaned on Gresham as well as other merchants to supply goods and funds for the war effort. But by that time, a prior two decades of wars had prompted Henry to begin watering the pound. What had been a currency backed by and in fact made of 100% sterling soon became a currency that was 90% sterling. When economic collapse did not ensue (though the economy was far from healthy), Henry debased the currency further, until the pound's silver content had fallen from 10 ounces to 4. With each decrement Henry found that life went on, so he would cut another ounce.

Shopkeepers continued to accept pounds, but raised prices to account for the decreased substance of the currency. The same went for rents, and all other goods and services. Whenever possible, buyers offered "bad" money (pounds), and sellers took only good money (actual silver) whenever that was an option. The game went round and round, bad money slowly filling up the pool, until finally the most important participants, lenders (or bond buyers), balked at a pound backed by 4 ounces of silver instead of its original 10—at which point the house of cards collapsed in rampant inflation, poverty, and social unrest. What happened to the silver that had backed the pound? It disappeared…disappeared from view, at least, driven out by "bad" money. Just as true silver coins have disappeared from our change purses today.

It's not hard to argue that the Gresham Effect is pervasive in our society. What has not been watered down? Today it requires more than $10 to buy goods or services which cost $1 at the end of World War II: bad dollars have driven out good. The fact is that wherever you look, the world is only "40% silver."

Okay, okay, so the good old days were not always so good. But take a look at the chart on the following page, which we've adapted from a recent presentation in *Business Week*. It shows the difference between GAAP ("generally accepted accounting principles") earnings and "pro-forma" earnings for US corporations. GAAP earnings include what the accountants' association says you must report as earnings, including, in particular, one-time charges and the timing and characterization in booking income or expense. Pro-forma earnings are the earnings that corporations would like to claim are their true operating earnings without all these distorting one-time charges and special income-and-

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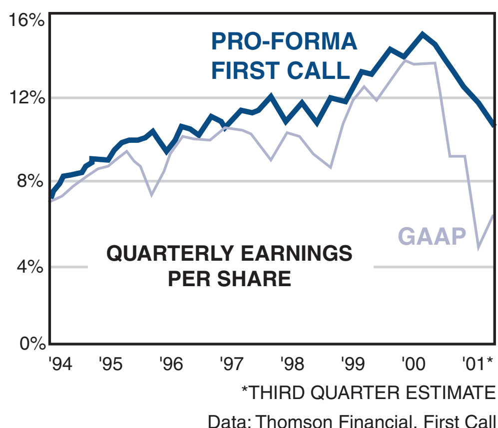


"Everyone is reporting not the earnings they have, but the earnings they can get away with reporting!"

expense rules that accountants say you have to use. It's the pro-forma earnings that get the headlines, though companies do have to offer GAAP earnings in their reports and in their SEC filings. In fact, the SEC only wants GAAP earnings. Why is that?

Note that for decades the difference between pro-forma and GAAP earnings didn't amount to much, and was often washed out over time. Even in the 1980s, when companies were constantly restructuring and taking major one-time charges, GAAP and pro-forma earnings tracked quite closely. Then, in the late nineties what one might think of as a Gresham's Convergence occurred. Investment bankers discovered they could sell a concept called the "new economy." Entrepreneurs and venture capitalists realized that if they could rustle up a company that fit into the picture, they could generate a big payday in the form of an IPO on the backs of stock market investors—selling stock to mutual funds hoping to boost performance, which would induce investors to give them money to manage for a fee. And just in that instant, an incredible number of technological developments, electronic and medical, spilled out of the minds of scientists and engineers to form the "content" basis of these new, new-economy companies. Maybe the engineering revolution came first, but it doesn't matter. The real point is that investment bankers discovered investors were willing to accept a watered concept of business accounting for these new businesses. And that meant they were willing to accept an accompanying watered concept of the value of this watered accounting. It was called new "metrics" for valuing companies, and it permitted bankers and the CEO talent they were promoting to propose nearly anything as a basis for value, including, finally, in the case of the internet companies, the value of so many millions of "eyeballs."

Now we see a sudden and radical divergence between GAAP earnings and pro-forma earnings. The New Testament rallies to defeat the Old. The earnings that investors are willing to accept from corporate statements are far greater than the earnings that the SEC requires companies to report. At the same time, companies who make free and loose use of the pro-forma concept are rewarded with stock prices headed out of the galaxy. Other companies, maybe older and more mature companies that should and do know better, start to creep into this game that the "bad" money has discovered. Soon everyone is doing it. Everyone is reporting not the earnings they have, but the earnings they can get away with reporting! Why? The investment bankers' tools of respectability, their analysts, are actually in on the con. Having taught investors to be obsessed with short-term earnings, they use the glowing earnings reports generated by pro-forma accounting to convince investors that a glass of water is actually a glass of wine. But when there are no more tricks left in a corporate treasurer's hat, investors find, through a single sudden announcement, that it was water indeed.

We've been shocked at the number of companies that ran out of excuses this year, and reported earnings at astounding levels of shortfall

SELECTED INDICES

	4TH Qtr'01	12 Mo
S&P 500	10.69	(11.88)
Equity Inc	7.48	(5.65)
Util Fund	(0.47)	(21.36)
DJUA	(1.54)	(26.08)
LB Treas	(1.96)	4.21
LBGC	0.06	8.50
S&P 400	17.99	(0.61)
Value Line	18.80	(6.08)
Rus 2000	21.08	2.58
Rus 2000 Val	16.72	14.03

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

from expectations. Other companies simply announced a radical change of business plan, with no warning at all. We're not simply nostalgic: the chart we've shown speaks volumes, we think. Companies' mendacity finally hit the wall this year, culminating in the most spectacular implosion—and the most spectacular example of corporate fraud—ever seen in American business, as Enron simply vaporized over a period of weeks. Last spring ENE was the seventh largest company in the US measured by sales. Late last summer every brokerage firm covering the company had a Strong Buy or Buy rating on its stock. Now it is gone.

But, in a sort of terrible denouement, this is the good news: CFOs, Boards of Directors, and investors alike have now seen the extreme destruction that can be borne of extreme dishonesty. Ratings agencies will not be as easily fooled as they once were. (Moody's, which was completely scammed, now rides about like the Arnold Schwarzenegger of balance sheets, forcing companies to button up or be cast on the junk pile. Let's note that Moody's is now a publicly traded stock, with its own public relations and valuations to worry about.) Companies, especially those with any connection to Enron's former businesses, are now under the microscope. We've often pointed to a kind of Heisenberg principle in investing: that which is closely watched changes, and is unlikely to manifest as feared or expected. We doubt that much new water will be poured anytime soon. Combined with low inflation, the quality of corporate earnings should improve radically going forward as a result of greater honesty and ethics in reporting, and this feature is highly likely to engender increased confidence among equity buyers. ❑

BETTER THAN BONDS | UTILITIES

Our portfolio far outperformed the Dow Jones Utility Index, and it continued to be a better home for investors' money than many if not most other areas of the equity markets. But we're surprised and disappointed with our absolute returns for the quarter, the second half, and the year 2001. While no strategy can be a winner every time, and we've certainly had our share of good times over the last ten years, a year without positive returns reminds us that investment is always a kind of battle, and the market, even in our highly stable area, has terrorist cells of its own.

As was true in the world and in other sectors of the market, we had much to fight in the past year—more than we can ever remember and far more than is probable for a single twelve-month set. It's startling to recall that natural gas prices had spiked to $10 (per MBTU, or Million British Thermal Units) as the year began, only to fall some 75% by the end of December (and our portfolio is heavily weighted toward gas-related utilities, for what we believe are very good reasons). At the beginning of the year, California was still in the midst of its electricity crisis, with prices north of $200 per megawatt—prices that fell some 85% by year-end as a result of conservation, a slowing economy, and new supply. At the beginning of the year, we suggested that utilities in general could use a bit of a rest, having just completed their best performance year ever. Little did we know that for the Dow Jones Utilities, all of 2000's gains would evaporate in 2001. On the subject of evaporation, just when we thought that prices had reached a compelling level of valuation last summer, along came the WTC attack in New York, quickly followed by the astounding collapse of Enron (and the subsequent panic among investors in any company involved in electricity production or trading, no matter how substantial the organization).

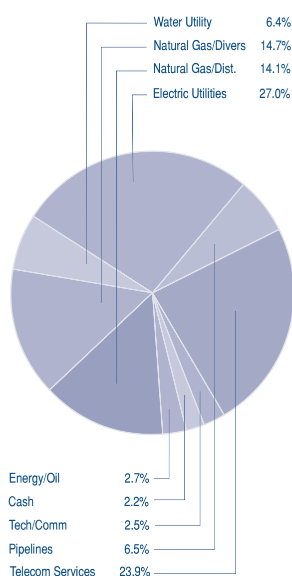
"...we had much to fight in the past year—more than we can ever remember and far more than is probable for a single twelve-month set."

Quarter Composite Net of Fees*	
BTB/Util (Preliminary)	(0.80)%
DJUA (total return)	(1.54)%
LBGC	0.06%
Ave Util Fund	(0.47)%

12 Month Composite Net of Fees*	
BTB/Util (Preliminary)	(14.62)%
DJUA (total return)	(26.08)%
LBGC	8.50%
Ave Util Fund	(21.36)%

5 Year Composite Net of Fees*	
BTB/Util (Preliminary)	11.22%
DJUA (total return)	8.98%
LBGC	7.37%
Ave Util Fund	7.82%

See Performance Disclosure on page 12.



With a couple of small exceptions in the telecom area, however, our stocks actually fared well through the year on the fundamental level. Even as many declined in price from already modest levels, their revenues and earnings continued to progress, and we had a significant number of dividend increases in the portfolio as well. Stock prices and company fundamentals began to diverge: it was a year in which investors had little appetite for equities, and even less for stocks that were remotely connected with the business or geopolitical events of the year. Even declining short-term interest rates, which would normally be seen as a positive, did not help: the more influential long bond rates diverged as well, and actually finished the year unchanged.

PORTFOLIO HIGHLIGHTS

For the quarter, we had some issues with fine bounce-backs. Interestingly, many were gas-related issues, such as Questar, MDU Resources (we increased our position in this one during the quarter), AGL Resources in a firm distribution group, El Paso Energy, and the seemingly ever-present Kinder Morgan Energy Partners. We also received Kinder Morgan common for our convertible preferred shares and elected to keep the common for now, as the stock has been strong and delivered a 15% gain for the quarter. The stocks that dragged down performance were frustrating, since underlying corporate performance was so strong. Williams was down, though earnings for the third quarter were up over 60% and revenues were up over 20%, and the company raised its dividend for the second time this year. NRG's 40+% earnings gain on a 50% revenue gain wasn't enough to inspire investors, even though third-quarter-end prices were modest indeed. Utilicorp had a 16% revenue gain and it too lost ground subsequently over the period. These were all companies—strongly weighted in the portfolio—touched by investor fears, in which the Enron situation reverberated.

Phones were also no help: though their fundamental situation is satisfactory, SBC Communications and BellSouth both offered double-digit losses, as much a result of correcting for price spikes at the end of the third quarter as anything else. We still consider the baby bells as rock-solid situations in the aftermath of turmoil created by telecom deregulation. We also gave up the ghost on Global Crossing. And we closed out our position in Montana Power, soon to become TouchAmerica (the company is in the process of selling off its traditional utility assets and retaining its telecom business), when the company postponed a number of important meetings. We still consider this one an interesting new entrant in the telecom world, and a company where the analysis can focus on operations since the balance sheet side doesn't appear to be an issue. We may return when the overall picture has greater stability and predictability.

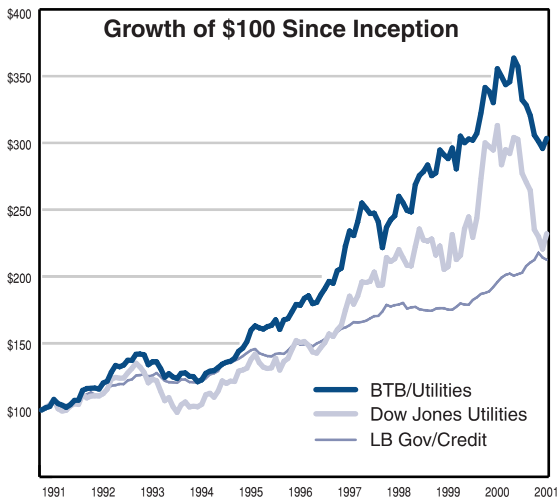
We added a moderate position in Mirant at the end of the quarter, and this represents a theme. What appears to investors in the independent power industry as chaos—in the aftermath of Enron's collapse and the subsequent downgrading of the credit ratings of a host of companies in the field—appears to us as a unique opportunity with only modest risk. Investors have reacted to the Enron situation as if an earthquake had occurred, and have ignored the reality that the very demise of ENE has produced a release of the "bad money" pressures that had earlier cast a pall on this industry of great promise and great national need. (You may recall that late in 2000 and early in 2001 we warned of the risks in this group both here and in national publications, though we had no grasp of just how bad things might get.)

There is substantial need for new power plants both here and abroad. That much is inarguable and is a result, at least domestically, of the delay in new construction caused by the

UTILITIES PORTFOLIO CHARACTERISTICS

Beta*	0.45
Dividend Payout	43.69%
Sharpe Ratio	0.56
Proj Dividend Growth	4.18%
Treynor Ratio*	13.67
Current Yield	3.20%
Annualized STD	10.94
Market Cap (MDN)	$4.6 Bil
Price/Book	2.44
Quality (Equity Rating)	B++
P/E Ratio (MDN)	14.21

**Relative to S&P500, 12/31/91-12/31/01*



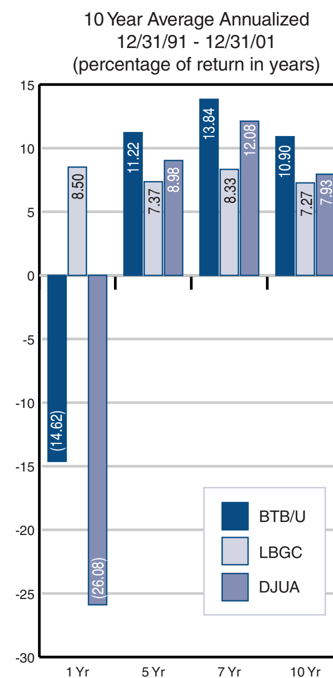
uncertainties surrounding deregulation. In most areas, reserve margins needed to prevent brownouts are well below historic levels. Many existing plants are at or near the end of their useful lives, and the digital economy has created a growth in electric demand that was unforeseen by planners (this is not so visible now, in a weak economy, but it will be as and when more normal growth resumes). But the issue that arose when Independent Power Producers were rising high was whether or not they would overbuild in their quest to fill the palpable power needs, turning the industry into a cyclical play. Demand for electricity is far more stable than demand in other truly cyclical industries, so cyclicality would never be as great. But even the whiff of a boom-bust cycle would cause investors to rerate their valuations.

Now that companies have been chastened by Enron's demise and subsequent credit downgrades in the industry, they are under the microscope. Most companies have taken steps to firm up their balance sheets, and those steps include a reduction of capital spending and new plants. Any potential overbuilding and consequent down cycle have been pushed out many years. Excessive trading and merchant activities have and will shrink. With Enron out of the picture, the remaining players who trade will have much more business; prices will be more volatile and firmer. Overall profitability and quality will be enhanced by new industry attitudes as well as improvements in economic activity. With less relative debt and greater cash flow to service that debt, credit ratings will improve.

LOOKING FORWARD

We will not see these stocks selling at valuations that are below those of low-growth distribution companies for very long. These, and many others in our portfolio, have reached the point where their P/Es are lower than their growth rates—a circumstance that reflects undervaluation and has not, in our memory, ever happened to us before. The distribution companies themselves have performed well on both fundamental and stock-price levels, and we see no reason for that to change. Consolidation activity is likely to pick up in 2002, both because acquirers have had time to digest earlier acquisitions from 1998-2000, and because the likelihood of repeal of the Public Utility Holding Company Act within the next few months has grown strong. Economic improvement will lead quickly to better natural gas pricing (there's actually a shortage of gas currently being masked by the slow economy and unnaturally warm weather). And the baby bells are in solid position for new growth now that competitive threats have faded. Overall, then, we find the stocks in our portfolio are well positioned and modestly valued. Our "call" of last summer remains cogent, we think. The events of this fall proved a notable intervention, but values and fundamentals rule in the longer run, and we believe conditions are excellent for a renewal of our historic double-digit long-term returns. We thought a buying opportunity was at hand last summer. The Enron disaster has only improved the situation, forcing firmer financial foundations in the power industry and instigating those enhancements at even lower prices. As the normally boring managers of a typically boring investment strategy, we're getting kind of excited. ❑

"As the normally boring managers of a typically boring investment strategy, we're getting kind of excited."



Quarter Composite Net of Fees*

Distribution (Preliminary)	5.12%
DJUA (total return)	(1.54)%

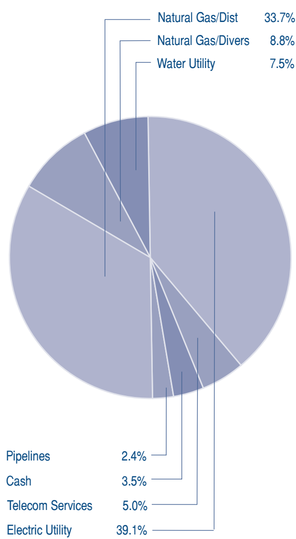
12 Month Composite Net of Fees*

Distribution (Preliminary)	(7.35)%
DJUA (total return)	(26.08)%

3 Year Composite Net of Fees*

Distribution (Preliminary)	12.97%
DJUA (total return)	1.69%

**See Performance Disclosure on page 12.*



FUNDAMENTAL CHARACTERISTICS

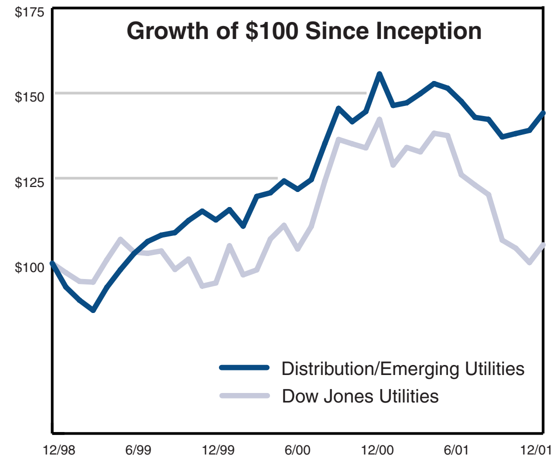
Yield	4.2%
Proj Div Gro	2.80%
Payout Ratio	58.79%
Market Cap (MDN)	$1.4 Bil
Price/Book	1.58
P/E Ratio (MDN)	12.85
Quality (Equity Rating)	B++
Beta*	0.11
STD	13.80

**Relative to S&P 500, 12/31/98-12/31/01*

Previously we've suggested that, in the absence of takeover activity, this portfolio would be largely influenced by the broader movements in the utility industry indices, such as the Dow Jones Utilities (here we buy and hold only stocks deemed to be takeover candidates in the various utility industries). But this is a portfolio of utilities untouched by the calamities of Enron and the independent power producers. Thus, with no takeovers in the past quarter, we were still able to generate very nice returns. And with only one takeover during the year, performance remained solid. This is especially true in view of the 38.06% return this strategy generated in 2000. On balance, with a return of 12.97% for the past three years, one could hardly have found a better—and less volatile—investment.

PORTFOLIO HIGHLIGHTS

The only problem lies in reporting. For without takeover activity, this is surely the dullest group of stocks on earth. They are the pipes and wires companies, the local regulated monopolies that plod ahead year-after-year with single-digit earnings gains, dividends in the 4–5% range, and dividend growth at a similar level. There are no substantial fundamental changes for any of our stocks, and therefore little to relate. Utilicorp, one of the few to feel the effects of Enron in this portfolio, has decided to buy back its Aquila marketing arm, having previously sold about 20% to the public at prices higher than today's market. Aquila is the merchant arm of Utilicorp, and the faster growing part of the company; upon completion of the buy-back, the entire company will be renamed Aquila. Otherwise, companies in the portfolio delivered earnings as expected (with plus or minus adjustments for weather), did not sell stock, did not sell bonds, and did not make any headlines.



LOOKING FORWARD

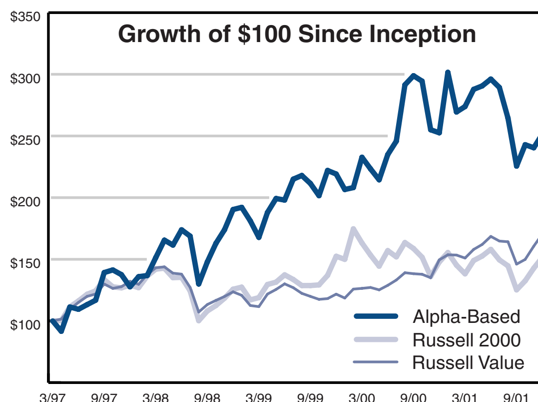
The next couple of quarters may not be so uneventful. By now, most of the more aggressive acquirers of the past few years have had time to digest their recent acquisitions, and most are in financial shape to support their acquisitive ways. Expect to see more activity from British and European companies in the coming months. Too, the comprehensive energy bill that was shelved in the wake of 911 will be back on the table now, and we expect to see repeal of the Public Utility Holding Company Act within the next three to six months. Observers of the industry on Capitol Hill are a bit more chary now than they were (another Enron effect), so there's likely to be a rather visible mechanism for merger approvals going forward. But the repeal of PUHCA has support from all three branches of the legislature, and it's a good bet to go down soon. That will mean that much more consolidation and convergence in the utility industries, particularly the electric industry, will be possible. Utilities, integrated oil companies, and financial players will all converge on this sector when the legal barriers to creating an enterprise with enormous scale are removed. At the same time, stock prices

continued on page 9

We had a solid quarter of performance in the Alpha-Based Strategy, though we came in under the Russell benchmarks, which were quite influenced by a technology bounce-back after the WTC attack. Strong recent performance is an indication to us that our efforts to refine the strategy in ways that address the challenges of an ever more volatile and skittish market are headed in the right direction. We've done much research in recent months regarding the importance of volume patterns and insider activity as predictive factors, and that work now appears to be bearing fruit.

PORTFOLIO HIGHLIGHTS

In the wake of September 11, we witnessed Americans *en masse* cocooning themselves in their homes. Consequently, our stocks in companies that produce home entertainment and creature comforts deserve much of the credit for our positive performance this quarter. To see this phenomenon at work, one need only look as far as: hair care and beauty product distributor, Helen of Troy; gourmet coffee roaster and retailer, Green Mountain Coffee; home fitness equipment developer and marketer, Direct Focus; and women's clothing retailer, Chico's FAS—with price appreciations of 11%, 20%, 24%, and 40%, respectively. Videogame distributor Take-Two Interactive, one of our worst performers in the previous quarter and a stock that saw a brief, two-day sell-off in December, appears to have finally gotten its ducks in a row. Throughout the holidays and continuing through January, TTWO had the number one selling Playstation2 videogame (Grand Theft Auto 3) and a top selling hit for the Playstation2 and Xbox (Max Payne), and is basking in expectations that it's highly anticipated releases in January and February are going to be similarly well received.



Since adding weight to our position on a mid-December air pocket, we've seen the price move some 76% higher.

We also saw renewed public and investor enthusiasm for the medical-supply and health-service industries as defensive plays with exceptional earnings growth potential including: Mid-Atlantic Medical Services, Trizetto Group, Vital Signs, Boron LePore, and Bio-Vascular.

We took gains of roughly 44% in Christopher & Banks and 36% in Priority Healthcare, and suffered moderate losses in Steve Madden and Vesta Insurance when their earnings took an unexpected dive. Presently, we're keeping a close eye on our somewhat troubled position in Fleming, the nation's largest food wholesaler and distributor, to see whether its $4.5 billion supply contract with Kmart is in jeopardy due to Kmart's costly and slower than expected restructuring. If Kmart can survive it's current woes, however, Fleming is likely to rocket skyward, strictly on fundamental valuation and earnings growth. Too, we're optimistic that the now dormant energy component of the strategy will contribute to performance when the economy shows credible signs of recovery.

LOOKING FORWARD

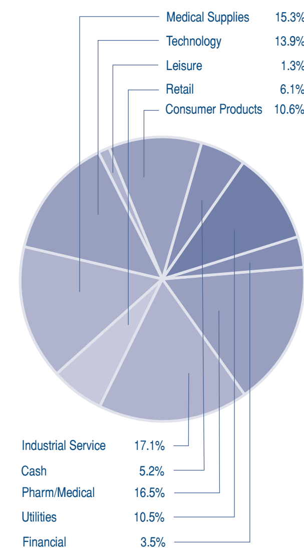
Whether the economy experiences a rebound in the coming quarter or continues to start and

continued on page 11

FUNDAMENTAL CHARACTERISTICS

Forward P/E Ratio (2002)	15.90
Market Cap (MDN)	$500 Mil
Price/Book	3.89
LT Growth Rate	27.29
Beta*	0.89
R-SQR*	0.30
Annualized STD	27.03
Alpha*	12.76

Relative to S&P500, 12/31/98-12/31/01



Quarter Composite Net of Fees*

Alpha-Based (Prelim)	11.73%
Russell 2000 Value	16.72%
Russell 2000	21.08%

12 Month Composite Net of Fees*

Alpha-Based (Prelim)	(0.48)%
Russell 2000 Value	14.03%
Russell 2000	2.58%

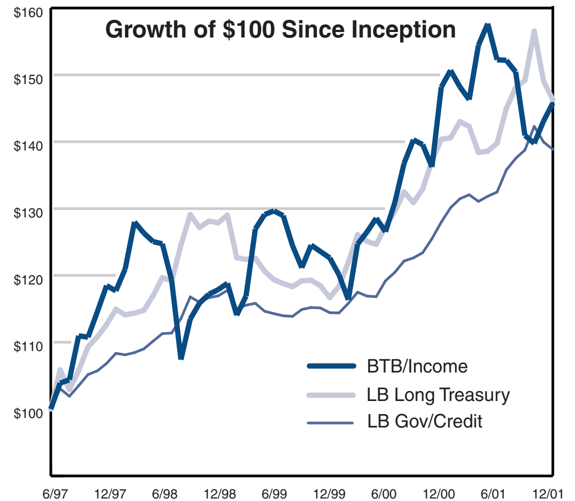
3 Year Composite Net of Fees*

Alpha-Based (Prelim)	9.74%
Russell 2000 Value	11.33%
Russell 2000	6.44%

**See Disclosure on page 12*

BTB/Income provided a solid quarter to finish out the year only nominally below flat—an accomplishment for any strategy this year. For the second year in a row, this portfolio has seemed to exist in its own world, providing a safe haven of returns even when the weather outside is raining. The diversification of industries has been a help, as have our specific stock selections, as well as the simple fact that companies that offer a high yield are cushioned against decline by their payouts. Where a tech stock might take a 50% dip at any time, the same decline would drive the yield on a stock paying 6% to 12%, inviting a stampede of yield hogs to feast on this lagniappe. Thus, our stocks, which offer earnings growth, growth of yield, and potential capital appreciation in addition to a high current yield, have managed to outperform the S&P 500 as well as long-term bonds over the past couple of years, as well as nearly every asset category in between during this dank and generally inimical period.

"For the second year in a row this portfolio has seemed to exist in its own world, providing a safe haven of returns even when the weather outside is raining."



Quarter Composite Net of Fees*

BTB/Income (Preliminary)	3.46%
LBGC	0.06%
LB Long Treasury Index	(1.96)%

12 Mo Composite Net of Fees*

BTB/Income (Preliminary)	(1.59)%
LBGC	8.50%
LB Long Treasury Index	4.21%

3 Year Composite Net of Fees*

BTB/Income (Preliminary)	7.36%
LBGC	5.90%
LB Long Treasury Index	4.58%

**See Performance Disclosure on page 12.*

PORTFOLIO HIGHLIGHTS

We didn't make a lot of changes during the quarter, though our few moves were effective. We had some housecleaning to do in letting go of Dana (for the time being) and the target term securities for JDSU, and we added a few items from different sectors. Viewing the disaster among the independent power producers as an irrational investor panic, we added convertible preferred shares for NRG (these offer a 9.10% yield, while the common pays no dividend). See the BTB/Utilities recap for more on our views regarding this industry. NRG is the cheapest of the generators, selling at about one-fourth of replacement value. But it has the backing of major utility XEL Energy (former Northern States Power and others merged), which recently committed an unrestricted $300 million to NRG as a capital infusion. Indeed, there has been quite a bit of buzz to the effect that XEL will "take back" NRG similar to Utilicorp's re-acquisition of the 20% of Aquila Energy it had previously sold to the public at higher prices. So there's a nice yield here, backing from a corporate sponsor, strong earnings growth, way low valuation, and takeover possibilities. Enough attraction to warrant entering the emotional froth of the current IPP world.

We've been doing well with REITs during a period that's been good for the group generally, and we added Equity Residential this quarter. It had been on our list of buy candidates, and when Standard & Poor's selected the company to be the first REIT in the S&P 500, we went along—since now every index fund is a potential buyer of the stock in addition to those who choose REITs on a more fundamental basis. We also added convertible preferred shares for Amdocs, an extremely exciting company that is the dominant factor in billing software and outsourcing for communications companies. This is a company on a strong earnings growth track, whose earnings and revenues rose in double digits each quarter of 2001. It was lumped in with tech stocks, however, and tossed from near 100 in 2000 down to below 30, where we bought the convert

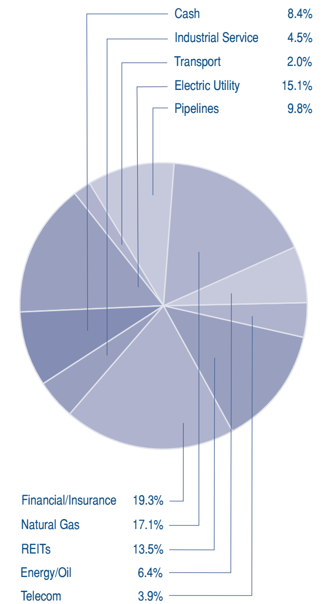
with a 4.4% yield. Even though it has risen 20% from cost as we write, the company still sells at a P/E similar to its growth rate, though its earnings stream is a result of contracts that stretch far into the future and is among the most reliable of any company. This is how we get appreciation potential into the portfolio without sacrificing yield.

A number of our existing stocks contributed in the same way this quarter. Our Vodaphone convertibles (MediaOne PIES) were up 10%. AES Trust convertible securities, which were a drag in the third quarter, were up 5%. Qualcomm equity-linked notes were up 3%. These are testament to the effects of diversification, picking up the slack as many of our energy-related companies suffered from a lack of conviction among holders and buyers.

LOOKING FORWARD

In our view, the broad market has support due to extreme liquidity, but only moderate upside potential due to the uncertain outcome of an excess-supply-led recession and current valuations that are not especially compelling. Yet, call us Pollyanna, we're not strongly convinced that the overall market will have such a big role to play in our returns. Perhaps we've just become mentally woozy due to lack of correlation with either equities or bonds over the past two years, but this portfolio increasingly seems to depend upon the investment merits of its constituents rather than the influence of larger asset-class movement.

And there does appear to be a universe of reasonably attractive candidates for our perusal. A number of companies have recently issued what we think of as "MBA" securities, (PEPS, LYONS, TIGERS, PRIDES, etc), all of which tend to be securities with a preferred yield that convert into the common in a specified time period. There are several new issues for companies in industries not currently represented in the portfolio that we may want to use once they are a bit more seasoned in the marketplace. There are also attractive utilities from our BTB/Utilities portfolio, many of which have had a difficult year due to investor fickleness and events at other energy corporations, but which are fine fundamentally. And a number of our holdings are deserving of higher weights now, as the premises under which they were bought have been fulfilled while the stock prices may not have yet responded. The quarter has started well, as we write, and we look forward to another period of moderate positive returns. Current yield for this portfolio is 7.0%, including cash. ❑



FUNDAMENTAL CHARACTERISTICS

Yield	7.0%
Proj Div Gro	5.25%
Payout Ratio	55.28%
Market Cap (MDN)	$3.5 Bil
Price/Book	2.38
Beta*	0.41
P/E Ratio(MDN)**	11.92
Quality (Equity Rating)	B++

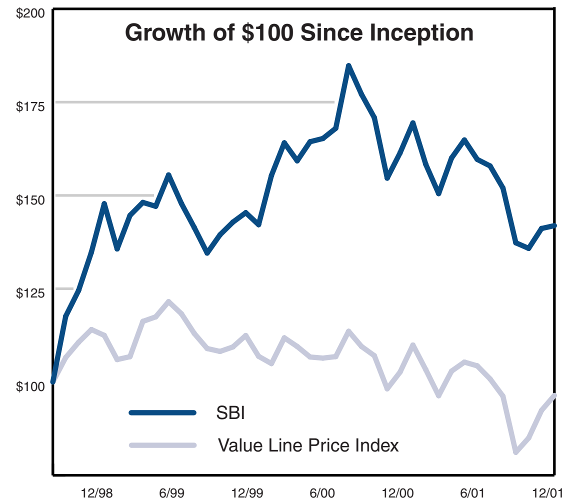
**Relative to S&P 500, 12/31/98-12/31/01*
***REITs use P/FFO ratio rather than P/E Ratio*

continued from page 6 - Distribution/Emerging Utilities

for generating companies, distribution companies, and integrated companies, are all modest indeed, and way below the private market values established by numerous deals over the past five years.

So we think there's still plenty of ore in this mine, and chances are good that 2002 brings a renewal of digging. The really nice thing about this strategy, though, is that even if we don't get the deals that we expect, we still hold a group of good-quality, safe, high-yielding equities with a history of modest growth, whose predictable volatility is hardly even in the same league as their potential for appreciation in a transaction. ❑

This quarter our more value-oriented approach didn't bounce as vigorously as the indices—it was a moment in the sun for growth stocks—and we had a couple of individual situations that dragged down returns. However, we ended the year better than the S&P 500 but not as strong as the Value Line, which we consider a better benchmark since it is not capitalization weighted and is much broader. Still, with the average large-cap fund down in the mid 20% range, last quarter's sudden bounce was not a great deal more than minor relief for the aches and pains experienced by most equity investors.



"But despite a general market that few could describe as 'cheap' right now, we are finding an ample group of candidates."

PORTFOLIO HIGHLIGHTS

Pharmaceuticals, the highlight of our last report, reversed and delivered several unpleasant surprises. Not all stocks disappointed, but the ones that did managed to leave a memorable scar on our hearts; energy was not the only area of the market to suffer from corporate mendacity and a basic betrayal of investors' confidence in corporate reporting. Alpharma and Watson provided noticeable negative returns when they reported earnings that were nowhere near expected growth and earlier company guidance. Indeed, Watson actually decided things were bad enough to change the essence of their business plan, and this came with no previous warning or intimation. Investors today tend to respond quickly to reports that undermine the *story* of a stock, and in this case we can hardly blame them. Sometimes a price decline inspires us to add more shares if we believe the fundamental investment thesis is still intact, but with Watson, we decided to cut our losses and use whatever tax benefit we could salvage. Merck is also a bit stalled now, but we bought the stock as a bottom-fishing, deep-value idea, and we're willing to be patient with it. Lowered guidance makes us uneasy about the near-term fundamentals, but the company is hardly without resources to return to its former glory, and investors just now are giving it no credit for what we consider a credible pipeline of future products.

We found two healthcare sector replacements to take the spots of our earlier holdings. In December we added Mylan Labs and TEVA Pharmaceuticals, companies we've followed closely for years, both with attractive valuation, outstanding financials, and strong wind to their backs in support of the growth of generic market. Generic drugs are big beneficiaries of a raft of drugs coming off patent recently and in coming quarters, with a market that has more than doubled in size in the past year, so we see this positioning as opportunistic as well as one with multi-year attractions. One of the recent events of interest during unstable times is a tentative approval given to TEVA to produce a generic version of CIPRO, a household name drug that's been dominating the headlines for quite some time.

Somewhat surprisingly, the best performer this quarter was Home Depot, gaining over 32%. In the face of dropping consumer spending and overly negative

Quarter Composite Net of Fees*	
SBI (Preliminary)	3.34%
Value Line Index	18.80%
12 Month Composite Net of Fees*	
SBI (Preliminary)	(12.09)%
Value Line Index	(6.08)%
3 Year Composite Net of Fees*	
SBI (Preliminary)	1.73%
Value Line Index	(5.45)%

**See Performance Disclosure on page 12*

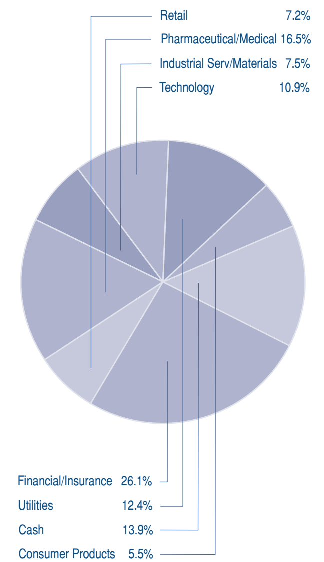
economic reports, our "do-it-yourself" chain kept chugging along at full steam. No doubt the fact that the housing market has hardly flinched during this low-interest-rate recession is behind the company's strength. A cunning discount program contributed to HD's success as well. We're always intrigued when a company so large and so widely watched delivers much better than expected performance, but that's what makes a market, we suppose. Long-time holding Toys 'R'Us continued its lugubrious recovery, as kids products, from Harry Potter gewgaws to the niftiest video games, yet again proved to be very resilient in bad times. Santa's category-killing senior helper bounced back to close the quarter with a 20% gain on projections of overall toy sales, rising as much as 2% this year after closing little changed in 2000.

Our technology holdings rebounded immediately after the markets opened in September, resulting in a steady and smooth performance throughout the quarter. SunGuard finally completed its purchase of Comdisco, which is an inexpensive strategic fit that should give next year's earnings a fair amount of upside. The acquisition gives this leading investment and banking processing services provider a New York City area presence. The stock is currently trading at modest valuations, has practically no debt, an excellent product roster, and a constantly growing client base with recurring revenues. Arbitron, a position we inherited from our position in Ceridian, continued strong, gaining close to 30% as investors embraced its impeccable financials, valuation, and underlying business model.

Banking and financial services stocks were flat, as investors pondered the situation of financial stocks in a future of inevitably higher short-term rates. In early November we took profits in AIG and recently added another bank, BB&T Corp, a full-service outfit with a superb SBI quality, attractive yield, and most important, an excellent relative valuation, which makes us hope that in due time we will have a takeover waiting to happen. In fact, the financial area is ripe with stocks that amply qualify for our portfolio, and we have to restrain ourselves here in consideration of prudent diversification.

LOOKING FORWARD

We are going to continue our search for quality within the various sectors. We're carrying some extra cash as a result of a cautious attitude toward the market and some year-end sales, which we hope to put to work in furtherance of our drive to get sector neutral. The nature of corporate profitability means we may have to "forgive" some recent earnings records, and there are as well certain areas of the market that will just never contain the kinds of companies we want to own. But despite a general market that few could describe as "cheap" right now, we are finding an ample group of candidates. Like most investors today, we have a greater sensitivity than ever to quality issues, and we have added many grains of salt to our interpretations of company guidance. ❑



FUNDAMENTAL CHARACTERISTICS

Yield	1.70%
Proj Div Gro	11.21%
Payout Ratio	15.90%
Market Cap (MDN)	$7.9 Bil
Price/Book	4.72
P/E Ratio(MDN)	21.26
Quality (Equity Rating)	B++
Beta*	0.85
STD	18.12

**Relative to S&P 500 12/31/98-12/31/01*

continued from page 7 - Alpha-Based Strategy

sputter, we feel confident that our strategy—emphasizing high alpha and low PEG ratios, supported by historically low valuations, and extremely high projected earnings growth rates— can be successfully implemented to meet whatever economic challenges lie ahead in 2002. And if the economy does begin to heat up, our smaller, more agile companies should be among the first beneficiaries. ❑

Performance Disclosure

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

Better Than Bonds/Utilities: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in the composite as of 12/31/01 was 310, which represents 94% of total assets managed in this strategy with a measure of dispersion of 0.51. Inception of the BTB/Utilities composite was September of 1991.

Better Than Bonds/Income: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. The number of accounts in the composite as of 12/31/01 was 81, which represents 52% of total assets managed in this strategy with a measure of dispersion of 0.40. Inception of the BTB/Income composite was May of 1997.

Distribution: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in composite as of 12/31/01 was 22, which represents 99% of total assets managed in this strategy with a measure of dispersion of .97. Inception of the Distribution composite was December of 1998.

SBI: Included in the results are all portfolios that are unrestricted and that have been managed for at least one full quarter. Number of accounts in the composite as of 12/31/01 was 9, which represents 52% of total assets managed in this strategy with a measure of dispersion of .49. Inception of the SBI composite was September of 1998.

Alpha-Based Strategies: Net of fees performance is based on actual results after the deduction of management fees (weighted average fee of 200 basis points). Included in the results are all Alpha-Based portfolios that are unrestricted, including one non-fee paying portfolio, and that have been managed for at least one full quarter. In addition, in order to be included in the composite, a new account has to be at least 80% invested and it should hold not more than 5% cash exceeding the maximum cash held by any portfolio already in the composite, as of the end of the preceding quarter. The number of accounts in the composite as of 12/31/01 was 75, which represents 88% of total assets managed in this strategy with a measure of dispersion of 0.44. Miller/Howard Investments has prepared all performance results. Inception of the Alpha-Based composite was March of 1997. Some accounts were in a modified version of the strategy; they became part of the composite October 2001. Portfolio was managed by William T. Chidester from inception through November 2000. Team managed since December 2000.

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