

## MARKET OVERVIEW

The first quarter lived down to our expectations (*“if anything we’d tilt to the negative for the broad indices, having already seen gains from the strong points present in the picture...”*), as a number of the goblins lurking beneath the stairs became palpable and real for investors over the past three months. It wasn’t a disaster for the broad market—though there were indeed some nasty pockets—and continues to fit within our longer-term picture of a trading range market that will need a good deal of time to work off the post-bubble trauma as well as time to work out the valuation tensions that have capped both upside and downside for equities.

Though there have been several false starts over the past two years, the seemingly inevitable upward re-pricing of interest rates appeared to have begun in earnest in February with a 7% peak-to-trough downswing. A January rally made the final quarterly net change for short and intermediate-term rates appear modest, but the combination of a poor technical picture and a recent noticeable uptick in the ISM inflation figures prompts us to think that the lows have been seen for the long cycle of interest rate declines that began way back in the early 1980’s. Counterbalancing this view are fairly punk employment numbers and the relentless increase in energy prices with their attendant dampening effect on economic growth. Indeed, many believe these two factors are inextricably linked, with higher oil and gas prices inducing caution among employers. Still, wages have risen even though gross job numbers haven’t, implying that inflation is creeping into the system at levels other than material and energy inputs. Even though growth may be inhibited by energy prices and modest job generation, credit market participants are on the alert for purchasing power degradation and, as we write, there’s little to inspire bond buyers. Nevertheless, there is a “conundrum,” to use Alan Greenspan’s term, in the fact that the longest bond maturities have remained relatively buoyant in the face of rising rates at the 10-year and less maturities.

There are a few ways to understand this. It’s possible, in today’s carry-trade world, that hedge fund and other aggressive participants are still finding ways to squeeze out a leveraged profit from the higher yields of longer-dated instruments, though the margins are becoming miniscule. It’s also possible that massive liquidations of long-term bond short positions are providing an artificial boost to the long end—which would be a negative since such affairs often end with a bell-ringing jolt. Unfortunately, there’s virtually no way to know for certain how significant the activities of secular players in the markets are at any given point in time, but we can at least suggest that they blunt the impact of a more conventional or classical interpretation. Such an interpretation would be that the credit markets

### THE STRATEGIES

#### INCOME-EQUITY STRATEGY

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

#### BETTER THAN BONDS/UTILITIES

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

#### DISTRIBUTION / MERGING UTILITIES

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

#### ABSOLUTE VALUE

An absolute return strategy designed to restrict downside volatility and enhance returns from a portfolio containing high-yielding, high-quality stocks. Layered below and above the base portfolio are hedge and leverage tools intended to prevent drawdowns and amplify gains.

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*"If one imagines such a thing as a 'cute' bear market...the probabilities seemed to have tipped in that direction."*

foresee shorter-term inflation and tightness in line with the Fed's current tightening program, but that longer-term the economy and the demand for money is expected to slow.

Recognizing that occult participants (including hedge funds and sovereign foreign governments) may have ideas and strategies that can upset the applecart, we still think that the larger force, the larger macro-economic picture, rules in the end. That would imply still more near-term difficulty from rates as economic momentum pushes forward, but an easing of the pressure later in the year when rising rates begin to bite and rising energy prices fail to relent (thus dampening economic activity). This is not the very best picture for stocks, since the markets are likely to discount a slowdown implied by this scenario—and various risks such as terrorist acts or foreign governments going on a dollar strike continue to need discounting in the market.

However, we're not intending to ring crisis bells. The jobs numbers tell us that this economy is not exactly as strong as many improvers of the breed would like to suggest, and persistent raw materials input increases help keep it from developing excess momentum. Too, international economies are not barreling ahead either. There remains more money than real economic places for it to go, and this supports both credit and equity markets. The problem is that bond investors can't be inspired by the signs of strength such as they are, and the signs of inflation. And equity investors are caught between continued full valuations coupled with prospects for higher rates now and slowing profits later—also an uninspiring combination.

Thus, once again, we don't envision large opportunities for equity investors in the upcoming months, nor does an "ugly" bear market seem in prospect. If one imagines such a thing as a "cute" bear market, however, as we write the probabilities seemed to have tipped in that direction.

A "cute" bear would include moderate

increases in interest rates, moderate softness (or lack of strength) in the dollar, slowdown in profits momentum, and minor panic consequent to continuing high energy prices.

Our "ten points" generally support this view:

- 1) *The Fed* continues to bring rates back to "normal" in 25 point increments. If history is any guide, the chances of them overshooting are fairly high.
- 2) *Terrorism* has faded as a front-page story, a factor that is always subject to instant change.
- 3) *Traditional Sentiment* measures (advisor bullishness, volatility index, short interest and the like) continue to argue against the upside. Those who have the microphone are rarely right, and they continue to voice bullish opinions, despite a softening of pricing. Last time we mentioned that the smoothly rising Advance-Decline line was due for a rest, and as we write it is taking that rest. The A-D line has broken down, terminating its previous trend, and we can't expect much from the market on a technical level until the A-D turns positive on a sustained basis once again.
- 4) *Our proprietary options indicator* continues, as it has for two years, to suggest modest downside risk. While the public speakers may voice bullishness, the options players with committed positions continue to view the market as risky. "Them that do" are still suspicious and sober—not the conditions for a melt-up or melt-down.
- 5) *Valuations* are still full, and it will take many quarters of income and balance sheet improvement (with in the absence of price depreciation) for them to decline to historic mid ranges. As investors we can never expect PE ratios to increase in the face of rising interest rates, so, while we don't envision extreme or very sharp rate increases, we do see rates rising and therefore no reason for valuations to improve.

#### SELECTED INDICES

	1 <sup>st</sup> Qtr'05	12 Mo
<b>S&amp;P 500</b>	(2.15)	6.69
<b>Equity Inc</b>	(1.60)	7.55
<b>Util Fund</b>	2.67	21.75
<b>DJU</b>	7.97	32.18
<b>LB Long</b>	0.52	2.78
<b>LBGC</b>	(0.67)	0.41
<b>S&amp;P 400</b>	(0.40)	10.43
<b>Wilshire 5K</b>	(2.39)	7.13
<b>Rus 2000</b>	(5.34)	5.41

S&P 500 = Standard & Poor's Index  
 Equity Inc = Avg Equity Income Fund (Lipper)  
 Util Fund = Avg Utility Fund (Morning Star)  
 DJU = Dow Jones Utilities Avg  
 LB Long = Lehman Long Government  
 LBGC = Lehman Bros. Gov/Credit Bonds  
 S&P 400 = S&P Mid Cap Index  
 Wilshire 5K = Wilshire 5000 Market Index  
 Rus 2000 = Russell 2000

- 6) *The dollar* has done better in recent months than many have expected—no doubt due to its doomsday appearance on the covers of most business magazines. Indeed, it's actually higher for the year so far (remember December, when we were about to become the next Brazil?) even though a couple of trial balloons suggesting Asian departure from dollar-buying were floated by foreign finance ministers. Let's face it, foreign governments don't have a lot of choices for massive savings/investment accounts, but they do have the option of hedging their dollar exposure. Can we imagine a world in which investment banks are not selling foreign governments on their ability to hedge currency exposure? No! The dollar could well surprise the bearish sentiment around it.
- 7) *Mutual Fund cash flows* were quite strong into equity funds all quarter. So much for the theory that money drives the market. Indeed, the fact that flows were positive and stocks still went down don't make the best bullish case.
- 8) *Earnings* seemed to us, last quarter, as the potential fly in the ointment that could make the market substantially worse than other factors might imply. We still see earnings as a goblin. Corporate costs are rising, but at the materials/energy level and, most recently, at the wage level. At the same time general economic growth is slowing, comparisons from recovery levels are getting tougher, and, once again, tech companies are complaining about "lack of visibility." A key ingredient in the picture, upside guidance from companies, is notably missing. We think the final implementations of the Sarbanes/Oxley legislation are a long-term positive in terms of quality of earnings, but for now the result has been one company after another finding itself forced to delay current reports and restate past

- reports. Without strongly rising earnings, and with downward pressure on multiples due to rising rates, what forces will prompt investors to pay higher prices for equities?
- 9) *Hidden taxes* from energy costs continue to drain consumers of buying power and continue to tax corporations at the margin. Inevitable bracket creep from attempts to shore up entitlement programs will add another layer of unexpected taxes on consumers, and one shouldn't forget the continuing "Iraq tax." The best one can say about these hidden taxes is that they argue against higher interest rates.
- 10) *Insiders* are still staying home. We note a bit more buying activity in selected issues, but the buy/sell numbers are still overwhelmingly bearish. Again, the continuing question: if insiders won't buy their own shares in today's environment, why should we?

Honest, we'd rather be bullish. But the trading range idea still obtains, in a market that's made no net progress in a year. We expect modest declines, punctuated by modest rallies, but little overall change barring a major change in the macro factors.

As we noted last time, the threats in the picture are greater for the average stock than for our higher yielding companies. There is an epochal return to quality companies that share present prosperity with owners, and there's no reason to think that this long wave is anywhere near a crest. Our stocks outperformed the market this past quarter, and we think they will continue to do so. Contrary to popular opinion, it is not the dividend-driven stocks that suffer during a PE compression induced by higher interest rates, it is the higher PE and more aggressive stocks, like Large and Small Growth categories this past quarter, that produce the minus signs. □

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

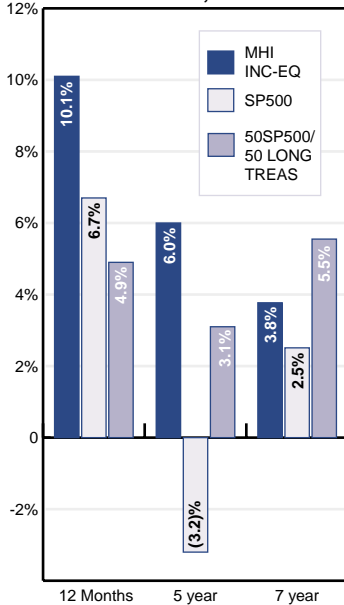
At the end of the 4<sup>th</sup> quarter 2004 we suggested that life had become a bit steamy and overdone for both the broad market and for some of our stocks, though none of our holdings really inspired anything like vertigo, and the values remained solid. This past quarter events in the market unfolded fairly true to our suggestion, with a corrective phase pushed forward by rising interest rates, albeit a phase in which our portfolio was one of the better performers in the market.

Elsewhere in this quarterly review we've made a point on which we've been harping for a couple of years, but which is worth repeating: in times of rising rates it is other, aggressive, non-dividend paying stocks which are hurt more than quality yield stocks, for the higher PEs of other groups compress in response to increasing rates—and that damage is far greater than any new yield competition for stocks that pay a stream of cash to investors. It's true that there's often an initial jolt when the rate picture starts to change—this happened in March of 2004 as well as the quarter just past—but companies with real value, real earnings, and real payouts quickly stabilize in a changed environment.

## PORTFOLIO HIGHLIGHTS

There were only a handful of notable price changes in the portfolio, as most stocks, when the ups and downs were tallied, finished little changed. The best gainers were all connected with some area of the energy industry, as one might expect in a market whose obviously highlight sector was energy. This portfolio isn't loaded with energy, but our representation in stocks like BP (up 7%), Tidewater (new last quarter, up 9%), and ONEOK (up 8% on improving prospects overall) certainly aided performance and made a statement about the value of diversification.

Annualized Returns as of March 31, 2005



### Quarter Composite Net of Fees\*

Income-Equity (Prelim) 1.95%  
50/50 SP500 & Long Treas 0.78%

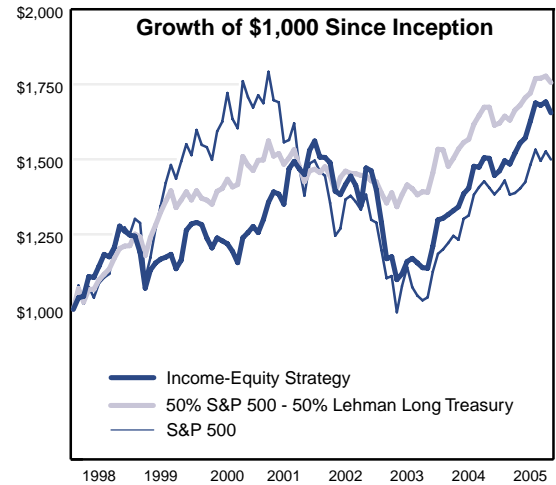
### 12-Month Composite Net of Fees\*

Income-Equity (Prelim) 10.09%  
50/50 SP500 & Long Treas 4.90%

### 5-Year Composite Net of Fees\*

Income-Equity (Prelim) 5.97%  
50/50 SP500 & Long Treas 3.07%

*Included are all unrestricted portfolios that have been managed for one full quarter. As of 3/31/05: 327 accounts in composite, representing 48% of total assets in the strategy with a dispersion of 0.40. Inception: 5/97.*



On the downside, our initial move into small company Startek was saved from disaster mostly by being a small initial position. The company offered a relatively soft earnings report, but the real killer for this one was the surprise announcement of its CEO's departure. No reason was given and no details provided, and we could hear villainous music in the background. Ordinarily this would be reason enough for us to exit the stock, but investors were ready to shoot first and ask questions later; the stock gapped down by 20%, leaving us somewhat hung in the position and awaiting more information.

However, a similar diversification effort, into electronics manufacturer and small-screen specialist Nam Tai bore much more edible fruit. This time we entered the position on a great earnings report and a near-tripling of the dividend; the stock is up about 20% from cost. A steady flow of good news regarding contracts and the company's upbeat view of future earnings has ensued.

Last quarter we noted the portfolio enhancement that special dividend stocks have been providing, and this quarter we became involved in two more. This area has begun to seem to us like a special category of dividend growth stocks—when we like the company overall, when it represents good value, and

when the special dividend is not some kind of razzle-dazzle paid for with company borrowings. We want companies that are actually paying out surplus cash that's built up, and have decided to share their current prosperity with investors rather than overreaching for growth that may be chimerical. Typically they'll also provide a "normal" dividend, so, in effect, these are good companies that we'd want in the portfolio—but their yield would be too low for our standards in the absence of the special dividend.

Our two new special dividend companies offered lush payouts indeed. Fidelity National Financial, the country's largest mortgage insurer, provided a \$10 cash payout (plus the regular dividend) on our original cost of \$44, for a roughly 23% special. The company has been doing well in its core business, but it also has a financial information technology and service business hidden within its structure for which the market has not been paying up. The company executed a somewhat complex deal and took on well-known venture investor Thomas Lee for 25% of the data subsidiary, retaining 75%, shifting the subsidiary debt to the subsidiary itself, and rewarding the common shareholders with cash. Interestingly, on the ex-dividend date the stock dropped only about \$8, not the \$10 that was paid, and we're currently ahead of the game on our original cost. It's likely that the next stage of this saga is a spinout of the subsidiary, and we're being paid to wait.

We also became involved in re-insurer Montpelier Re Holdings when it announced a \$5.50 dividend paid for from cash surplus. Here the stock price fully discounted the dividend on the ex date, but we bought well so the result is neutral so far. Subsequent to our purchases the stories for both FNF and MRH tarnished just a bit, (mortgage insurance pricing is becoming a bone of contention in California for FNF, a new and skeptical focus on the insurance industry

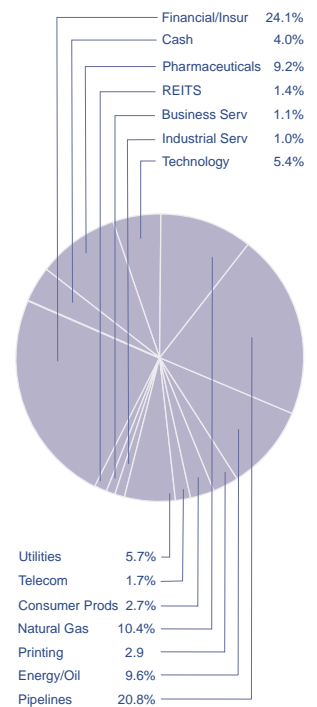
in general for MRH) but we think this is minor noise at this point and intend to hold both stocks.

Also notable in the portfolio was a déjà-vu hiccup in the MLP stocks that was similar to 2004. You may recall this group went on to become one of the best performers of 2004. Indeed, as of this writing they are once again positive on price for the year, plus their extraordinarily large distributions continue to flow. We do think these stocks are somehow involved in hedge fund carry-trade strategies, as a day or two of sharp drops came days after interest rates spurted up, not simultaneous with a rate change, making the activity suspicious in our eyes. In any event the fundamentals here are quite intact, with a far better yield and better growth than the overall market, so we continue to be buyers.

## LOOKING FORWARD

We're about where we were. We continue to like our stocks as excellent long-term values, and we continue to find new candidates to populate our "bench," especially as the generally choppy weather across the broad market produces bargains in stocks that are the subject of irrational selling. Right now there are no new attractive special dividend issues, but we'll always make room if one turns up, especially if it can diversify our sector representation.

The current yield for the portfolio, forward-looking and adjusted out for recent special dividends, is 5.4%. Actual income yield over the past 12 months was 7.2%. Note that the higher actual annual yield was the result of first quarter special dividend accruals which drove the portfolio's cash earnings to a rate of 2.33% for the *quarter*—a whole year's income for an index portfolio. That would bring in 9.3% in income for the year if sustainable, which, alas, it probably is not. □



## FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	5.4%
<b>Proj Dividend Growth</b>	4.2%
<b>Payout Ratio</b>	51%
<b>Market Cap (MDN)</b>	\$6.5 Bil
<b>Price/Book</b>	2.6
<b>P/E Ratio**(MDN)</b>	13.4
<b>S&amp;P Rating</b>	BBB+
<b>Beta*</b>	0.5
<b>Standard Deviation</b>	12.5

\*Relative to S&P 500,  
3/31/00 - 3/31/05

\*\*REITs use P/FFO ratio

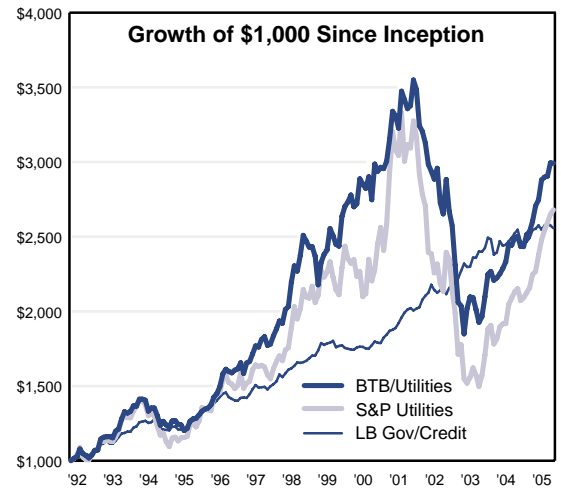
## Income-Equity (No MLP Version)

Quarter (net of fees)	(2.84)%
12-Month (net of fees)	9.14%
Yield	5.0%

*“Everyone likes to ask us ‘what happens if interest rates rise?’ as if that were some factor unique to our stocks and not applicable to the broader market.”*

It’s becoming a habit: once again utilities surprised investors by clocking in as one of the top performing sectors of the market, and one of the few to actually provide positive returns. And this occurred despite rising interest rates for the quarter. Whatever happened to the “interest sensitive” utilities you hear so much about on TV and in the popular business press?

As we’ve been noting for some years, the last time utilities had any sensitivity to interest rates was 10 years ago, in 1994. Since then performance has been random relative to interest rates. A perfect correlation between asset class movements is denoted as 1.00, but the correlation of our portfolio to rates over the past 10 years has been -.12. Everyone likes to ask us “what happens if interest rates rise?” as if that were some factor unique to our stocks and not applicable to the broader market. We have always said that it depends on the velocity and magnitude of rate increases, but that in general rate increases are not a good thing for any financial instrument, whether that be real estate, common stocks in any category, bonds, etc. In the case of bonds, rate increases are certain to produce portfolio value losses. In the case of stocks, actually the non-dividend paying stocks are more vulnerable, since they tend to sell at high PE ratios, which compress when rates rise. This past quarter provided some evidence of that, as growth stocks were the worst performers. Indeed, over the past ten years our utility portfolios have been among the *least* sensitive strategies to interest rate changes, and, we’d be remiss not to note we’ve outperformed the risk-adjusted S&P 500—even despite a “hundred year flood” post-Enron in 2002. It is not just that utilities comprise a good sector with relatively reliable returns, it is that utilities are a *good investment*. There aren’t that many other areas where it is so accurate to say “we can’t live without them.”



Once again the large-cap utility indices were more volatile on the upside than our portfolio, and once again the “blame” lies at the feet of the large-cap nuclear electrics, in particular regarding TXU, which has been so hot it registered a quarterly gain of 25% on top of triple-digit gains last year. But we think TXU, as well as a coterie of stocks which have driven the large-cap indices over the past couple of years (PCG, EIX, etc), has reached full valuation. It won’t be long, we think, before investors searching for better valuations along with consistent growth, begin to show a preference for our mid-sized to small-cap, well-run utilities.

## PORTFOLIO HIGHLIGHTS

About two years ago we replaced large-cap telecoms in our portfolio with natural gas producers, viewing the former as a group with many headwinds, and the latter as driven by massive and historic tailwinds. This past quarter our move continued to bear fruit, as investors came to realize they had underestimated the forces at work producing higher energy prices, and realized at the same time they were shortweighted across the sector.

Our interest in energy has been primarily in gas, since all the new electric generation

### Quarter Composite Net of Fees\*

BTB/Util (Preliminary)	3.24%
S&P Utilities	5.41%
LBGC	(0.67)%

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

BTB/Util (Preliminary)	19.67%
S&P Utilities	24.53%
LBGC	0.41%

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

BTB/Util (Preliminary)	8.83%
S&P Utilities	8.13%
LBGC	7.21%

*Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 3/31/05: 159 accounts representing 94% of assets in the strategy, with a dispersion of 0.29. Inception: 9/91. History includes one institutional client, 45% of the composite, that held a 2% position not held by others in the composite.*

capacity added in the past ten years has been gas-fired, and we have been able to say that, at the margin, in effect, gas is equivalent to electricity. It is as though history has made a grand circle, and the fuel that powered lights at the turn of the century now does so again. Our gas-producing companies hit new highs across the board this quarter: too bad we limited ourselves to less than 20% of the portfolio, out of normal fiduciary prudence! Anadarko rose 17.4%, Burlington 15.1%, Devon 22.7%, EOG 36.6%, Pioneer 21.7%, and our long-time holding Questar rose 16.2% to a level nearly four times our original purchase in the late 1990's.

Under ordinary conditions that performance, even on a single segment of the portfolio, would have been enough to send our return substantially higher than the larger indices. So it's doubly frustrating to have to compare against some inflated issues which are arguably overpriced on fundamentals now, even when our gas stocks still are notably undervalued on the assumption, which we're willing to make, that gas prices continue to stay high. As we write June gas futures are nearly \$8.00. That is a record by far. And a merely normal summer (which we haven't had for the past two years) will trigger large-scale use of combined-cycle gas generation plants which will make \$8 look like a bargain. This is the third time we've anticipated a "summer surprise," and we're hoping the third time will be a charm.

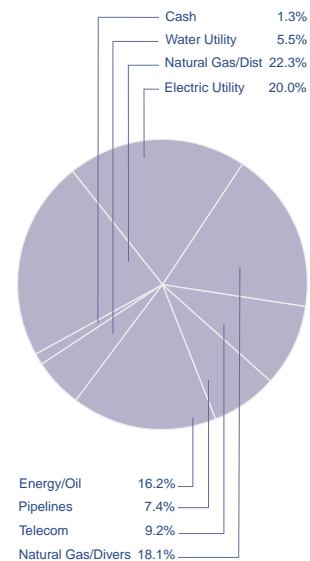
Elsewhere, sluggishness in the distribution stocks we hold dragged down overall performance this time. Our new holding Sierra Pacific (also upweighted this quarter) performed well (+2.3%), but, more importantly, another brick in the wall of its long-term story was mortared in during the quarter when a FERC panel determined that Enron had engaged in illegal activity when it induced the company to enter into a supply contract, the terms of

which have been lately looming over the head of SRP as it attempts to recover from Enron-era problems that were not of its own making. We also took a small trading position in takeover idea Brazil Telecom, thus far to little effect.

### LOOKING FORWARD

Clearly the constituency for utilities has become re-established over the past few years, escaping the long shadow of Enron and associated companies as the industries set about vigorously on a "return to basics" program. Few issues are anything but plain vanilla now, and they are benefiting from better management, cost controls, generally congenial regulation, and the steady growth of electric, gas, and water usage in the country. Deregulation is not dead, but it's pretty dead as far as any impact on investor-owned utilities today. The companies have "normalized," dividends are safe and growing once again, and investors have a newfound appreciation of mature, capital-intensive businesses with high barriers to entry. The floor is a lot higher than it was.

That said, we think the chances for eye-opening gains from some of the previous leaders—stocks that dominate the large-cap indices—have diminished. Nevertheless, we hold many smaller companies with fine prospects that are not selling at the high end of their historic valuation ranges, many of which are excellent takeover candidates in a world that we believe will see considerable consolidation over the next couple of years. These, combined with gas companies that continue to be underpriced relative to the value of their product (many of these companies were built on the assumption their gas would sell in the \$3 range), provide a solid confidence level for us in the prospects for this portfolio in the months and quarters ahead. □

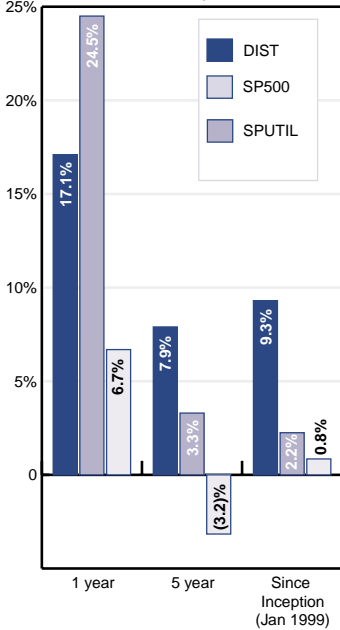


#### FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	3.4%
<b>Proj Dividend Growth</b>	5.5%
<b>Payout Ratio</b>	48%
<b>Market Cap (MDN)</b>	\$4.1 Bil
<b>Price/Book</b>	2.0
<b>P/E Ratio (MDN)</b>	15.3
<b>S&amp;P Rating</b>	BBB+
<b>Beta*</b>	0.6
<b>Standard Deviation</b>	13.6

\*Relative to S&P500, 3/31/95 - 3/31/05

**Annualized Returns  
as of March 31, 2005**



**Quarter Composite Net of Fees\***

Distribution (Prelim)	2.37%
S&P 500	(2.15)%
S&P Utilities	5.41%

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

Distribution (Prelim)	17.14%
S&P 500	6.69%
S&P Utilities	24.53%

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

Distribution (Prelim)	7.89%
S&P 500	(3.16)%
S&P Utilities	3.31%

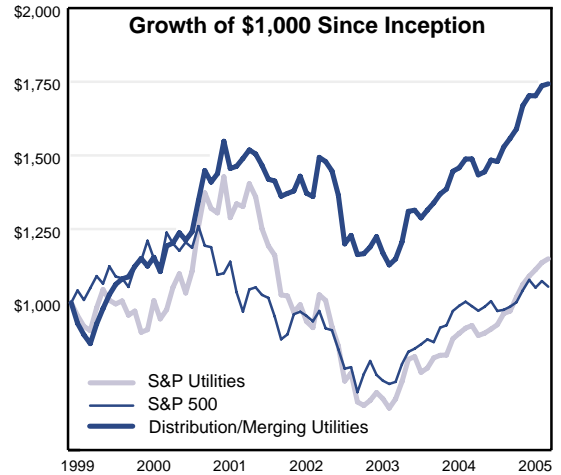
*Included are all unrestricted portfolios that have been managed for one full quarter. As of 3/31/05: 151 accounts, representing 93% of total assets managed in the strategy with a dispersion of 009. Inception: 12/98.*

The Distribution/Merging Utilities strategy delivered its eighth consecutive positive quarter in an otherwise turbulent and mostly negative quarter for the capital markets. Our stocks were helped by a generally firm utilities sector, and once again performed well without any deals. Meanwhile, prospects for an energy bill are better than they have been for the last three years, and such a bill would likely be a catalyst for our portfolio.

The House Energy and Commerce Committee is expected to begin work on the Energy Policy Act of 2005 during the first full week in April. The House version should look very similar to the last energy bill attempted about a year ago, and House passage is virtually assured. The Senate Energy and Natural Resource committee will likely begin their version later in the month. This time around there are four more Republicans, and opening of the Alaska Wildlife Reserve to drilling is not part of the new bill—and ANWR was a deal breaker last time around.

Do we need an Energy Bill? The energy issue is far more fundamental than just high commodity prices, tax incentives, or increasing supply. Nothing works in our economy without a sound energy infrastructure. Many of the regulations around the critical infrastructure in this country are outdated and inhibit the upgrading and expansion of the system. Our grandfathers built much of the critical infrastructure that supports our economy today, and a 100-year-old infrastructure simply won't cut it in a globally competitive world.

The administration is fully behind improvement and change. President Bush said recently, "A sound Energy bill must meet four objectives: it must promote conservation and efficiency, increase domestic production, diversify our energy supply, and modernize our energy infrastructure." He went on to discuss



the importance of electricity reliability, the need for the industry to make transmission investments, and support for the repeal of the Public Utility Holding Company Act of 1935 (PUHCA). The President said the law "prohibits new investment when it comes to expanding the transmission of electricity." Repeal of PUCHA, as we've noted many times, is likely to lead to a symphony of consolidation in our portfolio, as well as open up new investment opportunities in areas such as transmission.

There are several key areas that will likely be addressed in an energy bill.

- **Repeal of PUHCA.** This could significantly add new sources of capital to this already very capital-intensive group. Beyond potential M&A activity and economy of scale benefits, new partnerships could be formed to fund much needed expansion projects and improvements.

- **Mandatory reliability standards and increased enforcement authority for the Federal Energy Regulatory Commission (FERC).** The blackout in the northeast pointed to this need. Reliability standards should act as a catalyst for consolidation as well as organic growth of utilities' regulated assets.

- **Alternative and renewable energy incentives.** Some support for this was in prior legislation, but more comprehensive and long-term policies need to be put in place. Clean

coal technologies and renewed support for new nuclear development appear to be widely supported, if debatable, elements.

- Permitting and construction support. A federal framework for the permitting process and building of critical interstate infrastructures makes logical sense. LNG facilities, pipelines and transmission are all examples of beneficiaries.

## PORTFOLIO HIGHLIGHTS

During the quarter we sold Sempra Energy, and added Progress Energy, Western Gas Resources and Centerpoint Energy. We also increased our position in Sierra Pacific.

While we still like Sempra Energy, it was fully valued subject to risk in the form of an impending large civil lawsuit which could be extremely costly if it goes against the company. We added Progress Energy (PGN) following the announced merger between EXC and PEG. Most of our holdings in this strategy have been in smaller traditional wire and pipe utilities, but given the valuation placed on PEG, a larger integrated utility, we think the door is now open for acquisitions involving seemingly weaker integrated utilities. Given the same valuation metrics as the EXC/PEG deal, we believe Progress Energy could be valued in the low to mid 50's, and it is strategically interesting as a sunbelt utility with operations in growth areas of Florida and the Carolinas.

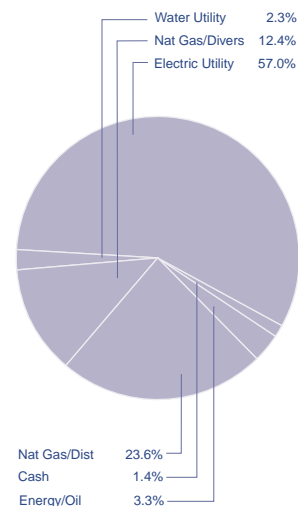
We also added Centerpoint Energy (CNP) during the quarter. The stock has been a wild ride for equity holders the last few years, but the future now looks quite tame. CNP is in the final stages of transforming itself into a pipes and wires company in Texas and 6 states with over 3 million customers. Their balance sheet has been improving and they're positioned to have solid and reliable positive cash flow with improving earnings by 2006. Also, based on

anticipated recovery of earnings, the valuation makes for an attractive entry point. We also added Western Gas Resources as a prime takeover candidate in an energy space that has seen many deals already, and doesn't require an energy bill for continued activity.

We increased our position in Sierra Pacific, and will likely add more as time goes by. We own SRP due to its attractive demographics, above average growth prospects, improving regulatory environment and built in regulatory asset growth potential. One of the overhangs to the stock has been the settlement ordered by the bankruptcy court that required SRP to pay Enron (ENE) approx \$336 million. The case is being appealed, but SRP was required to post about \$60 million in cash and escrow of about \$270M. Late in the quarter, (March 11) The Federal Energy Regulatory Commission (FERC) issued an order stating that ENE had engaged in illegal activity at the time they entered into contracts and that the contracts were signed under fraudulent pretenses. The FERC trial is scheduled to begin June 13<sup>th</sup>. Given the FERC order, chances of a favorable resolution are much enhanced, and would remove this overhang on SRP stock which would make it much more attractive to an acquirer.

## LOOKING FORWARD

The expectation of an energy bill has increased, but the success of our strategy clearly hasn't depended on it. The risk/reward ratio for this portfolio has been superior to nearly any other equity strategy for the past five years. We continue to tweak the portfolio to position it for success with or without M&A or the passage of an energy bill. But more than at any time in recent quarters, it certainly feels like spring is in the air and the portfolio is poised to benefit! □



### FUNDAMENTAL CHARACTERISTICS

Yield	3.3%
Proj Dividend Growth	3.0%
Payout Ratio	56%
Market Cap (MDN)	\$2.9 Bil
Price/Book	1.9
P/E Ratio (MDN)	15.7
S&P Rating	BBB+
Beta*	0.4
Standard Deviation	13.3

\*Relative to S&P 500,  
3/31/00 - 3/31/05

Last quarter we announced Absolute Value, an absolute return strategy for qualified investors.

Absolute Value is a dynamically hedged and enhanced strategy based on our Income-Equity portfolio. Layered below and above the Income-Equity long portfolio are hedge and leverage tools intended to amplify gains and prevent drawdowns. The goal is to maintain a high level of current income, permit the portfolio to participate in positive market periods, and hedge to prevent portfolio declines during negative broad market phases. The strategy has done very well indeed since inception (November 2003)—outperforming a difficult market by a wide margin, and outperforming the Income-Equity composite as well. In a nutshell, this strategy adds a layer of dynamic active manager skill to the effective long-term buy and hold approach of Income-Equity. It is a kind of fair weather friend strategy, hoping to capture all of the upside and diminish the downside over both short and long terms.

This past quarter was our sixth straight positive quarter since inception (including an initial “2-month quarter), though nearly every sector of the broad market was negative.

What were our sources of Alpha? Short sales of individual stocks played the biggest role. We shorted stocks whose valuations we perceived to be on the silly side, and shorted them when our technical discipline indicated that the time was right. We had successful forays on the short side in Urban Outfitters, Overstock.Com, Harmon International, Chicago Mercantile Exchange, and Cheniere Energy. We’re especially pleased with this last item, since it wasn’t easy to make money on the short side with an individual energy stock this past quarter. All of our individual shorts were profitable, with

Overstock adding the most to the portfolio in absolute dollars.

During the early part of the quarter we also boosted performance with selected long trades, mostly using bottom-fishing or proprietary anomaly techniques, in Merck, Rockwell, Rohm and Haas, Medtronic, Buckeye Partners, and Energy Transfer, balanced against small losses in Monsanto and Chiron.

February was positive but mediocre because the signals were such that our index hedges came off slowly—this comes with the territory on occasion, and needs to be seen as an insurance cost. We ranged from 100% hedged to 100% long at various points in the quarter, finishing the quarter fully long but winding up fully hedged within the first two days of April. These tiny trading ranges at the index level can lead to substantial churning with no real result. Over the course of the quarter our hedges added only about 1 percentage point of our total excess return, but we were fully protected much of the time.

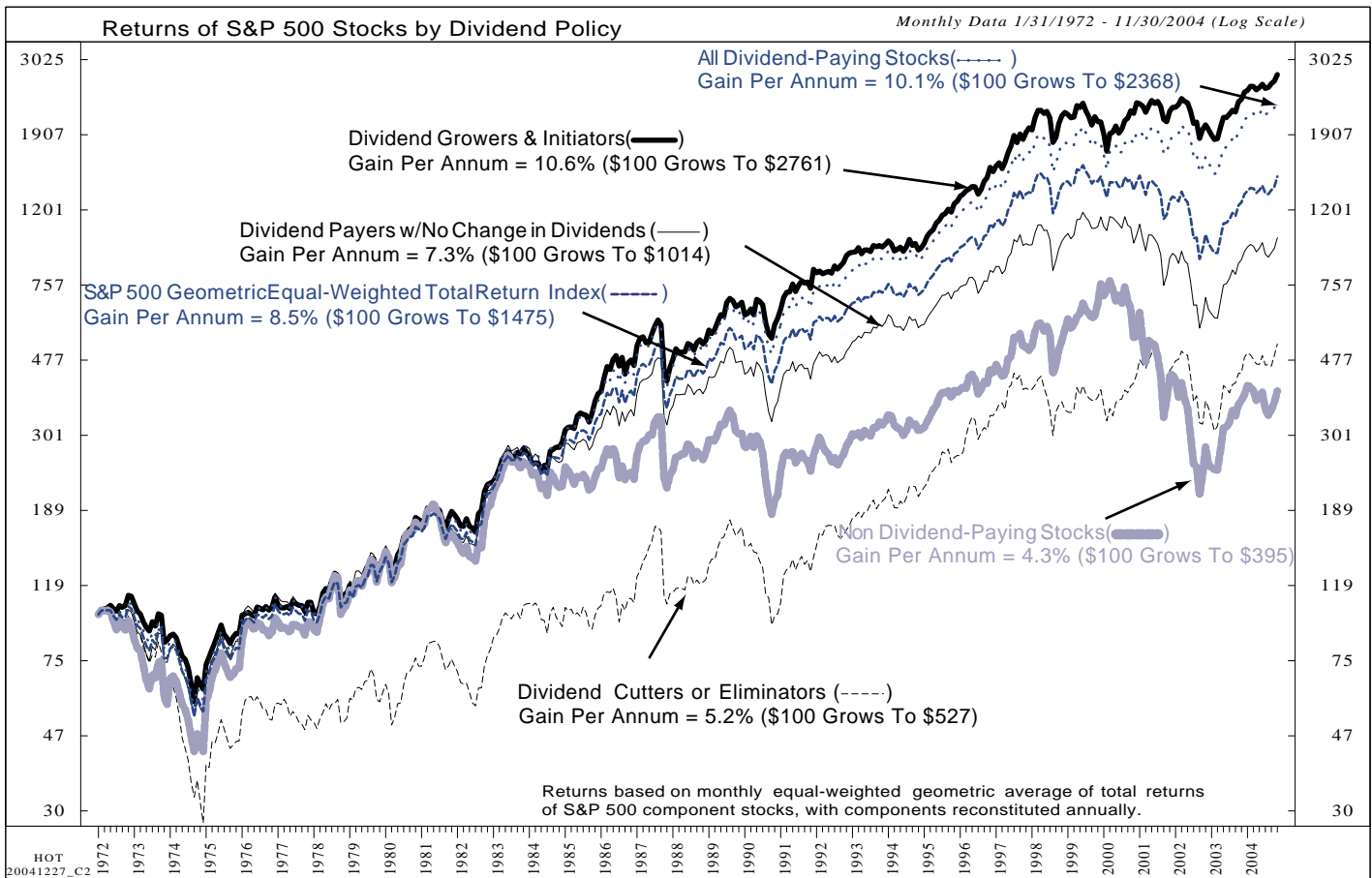
Looking forward, we still hold the view that a narrow trading range environment will continue, and we’ll do what we can to make the best of it. We’ll use the insights we’ve gained and the tools we’ve developed over the past 18 years, encompassing both the fundamental and technical realms of the equity markets, to adapt and adjust to new dynamics that develop, extracting alpha as we find it.

For further information please contact Helen Hamada for a brochure and performance information. □

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*“The goal is to maintain a high level of current income, permit the portfolio to participate in positive market periods, and hedge to prevent portfolio declines during negative broad market phases.”*



Used with permission from Ned Davis Research, Inc.

This chart from Ned Davis Research, Inc. (showing that non dividend-paying stocks grew from \$100 to \$395, while dividend growers and initiators grew from \$100 to \$2,761 during the same period) brings to mind Lowell Miller’s book, *The Single Best Investment* (1999, Adams Media Corp). Lowell Miller is the founder and CIO fo Miller/Howard Investments. Here is an excerpt:

...A moment’s reflection will confirm for you that this is an absolutely powerful secret, and yet there are very few investors actually using it. If this were not the case, if this factor were in widespread use, you would see a nation of happy investors whistling their way toward retirement. But you don’t. All you see are nervous nellies, checking the price of the Dow Jones daily and intra-day, scanning the most-actives list for some key to the future, subscribing to the newsletters filled with hyperbole and sketchy research, breathlessly hanging on every word of some smug talking head on the business news channel.

This hidden key is, in a simple phrase, dividend growth. As we know, mature companies pay dividends from their

earnings. Every quarter the company sends a check to investors, sharing a small fraction of the profits, and many investors love those checks. The feature that few have heeded, though, is that a significant number of companies raise their dividend every year (or nearly every year). To most, this seems merely a nice amenity, but because most people don’t have a long-horizon worldview, they totally underestimate the potency of this factor. It is, in fact, the electricity that will make your compounding machine run. It’s the gas for your engine. Dividend growth is the critical piece in the puzzle for creating a portfolio that will serve you over the years.

This is a simple idea, but is also the single most important idea for long-term investors. The reason it is so important is that dividend growth drives the compounding principle for individual stocks in a way that is certain and inevitable. It is an authoritative force that compels higher returns regardless of the other factors affecting the stock market.

You can read the rest of this chapter at: [www.mhinvest.com/sbi/dividend.html](http://www.mhinvest.com/sbi/dividend.html). Or we would be happy to email you the article. Send your request to [schun@mhinvest.com](mailto:schun@mhinvest.com).

“It was never my thinking that made me money but my sitting tight”

- *Jesse Livermore*

Author of *Reminiscences of a Stock Operator*

Our conservative, dividend-oriented portfolios invest in  
high-quality companies with rising income.

**MILLER/HOWARD INVESTMENTS DIVIDEND-GROWTH STRATEGIES**

PORTFOLIO	FOCUS	YIELD	EST. GROWTH OF YIELD	5-YEAR BETA	P/E	1-YEAR NET OF FEES RETURN
<b>Income-Equity Strategy</b>	Dividend growth companies, broad market	5.4%	4.2%	0.5	13.4	10.1%
<b>Better Than Bonds/Utilities</b>	Utilities sector: natural gas, electric, telecom, and water	3.4%	5.5%	0.6	15.3	19.7%
<b>Distribution/Merging Utilities</b>	Local distribution utilities, takeover candidates only	3.3%	3.0%	0.4	15.7	17.1%

as of March 31, 2005

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