

MARKET OVERVIEW

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 / EMERGING UTILITIES

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

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.

NOTE: The quarter report for the **ALPHA-BASED STRATEGY** can be found on our website, www.mhinvest.com.

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As a firm that specializes in managing portfolios of dividend-oriented stocks, we often find investors asking: “What about performance of these stocks when interest rates increase?” There usually seems to be a subtext to the question, an implication that the answer must be some shade of negative. In response, we’ve pointed out that: 1) a rise in interest rates is never *prima facie* positive for any financial investment other than bonds sold short, 2) many studies have shown that growth stocks suffer the sharpest drops in rate-induced general market declines, 3) our portfolios have had a negative correlation to movements in the bond market for the past ten years, and 4) if you are an investor who wants income as part of your package, increases in bond yields *guarantee* a decrease in the value of your principal, while equity investments may rise or fall, depending on the totality of circumstances. Our track record has often proven the above points, yet sometimes the ears of our inquisitors have been deafened by over-exposure to television business journalists or pundits with credible demeanors but very little factual or historic knowledge.

So we’re content right now. The bond market has just finished its worst quarter since 1980 – which was during the bad old days of rampant inflation. This past quarter, investors in intermediate bonds lost roughly 5% (depending on the bond, the duration, the credit rating, etc), while investors in long-term bonds lost 6 to 9%. But our yield-oriented portfolios were flat to higher, and our year-to-date returns are nicely positive. As was said during the preliminaries leading up to the first Iraq war, “no linkage!”

A focus on good value with a modest measure of growth in our yield-producing stocks, combined with a timely harvesting of profits and avoidance of excess risk has proven to be the right mix protecting our portfolios against rising rates. But relative performance comes and goes; what matters far more is the soundness of the underlying investment philosophy or strategy. For more on this, we include a special piece on dividends and the long-term investor later in our report.

Last quarter we suggested: “substantial [market] digestion is necessary before the future roadmap becomes clearer.” During the second quarter a sudden break in the bond market and major terrorism in Spain threatened to turn that process into indigestion. But the notion that we are in a trading range type of market – a view we’ve held for many quarters – still has substance. An improved economy with improved corporate earnings struggles against what seem to be inexorable interest rate increases stretching far into the future and prompting downward

"So the forces of improvement vie against incipient forces of restraint, and overhead rests a cloud of fear...."

revisions in valuation potential. So the forces of improvement vie against incipient forces of restraint, and overhead rests a cloud of fear regarding terrorism, plus one of uncertainty regarding the election. It's no wonder that trading volume, as of this writing, has slowed to a crawl. It is a Hamlet Market, in a time of smokey unknowns and goblins.

Our ten points haven't changed that much:

- 1) *The Fed.* On June 30 the Fed raised interest rates a whopping .25%, in a gesture more symbolic than practical. Frankly, we remain spooked by the abnormal level of rates, and we doubt the true causes will be understood until well into the future.
- 2) *Terrorism.* Leads to higher oil prices which leads to inflation (the real kind, not the government proclamations) which leads to higher rates, with a measure of fear thrown into the mix. This summer investors can contemplate terrorist potentials for the Olympics and two political conventions – features unlikely to motivate vigorous buying.
- 3) *Traditional sentiment measures (advisor bullishness, volatility index, short interest, and the like).* Though these indicators failed in 2003, they're still sensible (a peak of bullishness preceded the March-May correction), and if you think the majority of newsletter writers can't be right for very long, you'll have trouble being very bullish at the moment.
- 4) *Our proprietary options indicator.* Despite the above comments, our indicator has not been dented and remains bullish. Whatever fundamental concerns we may have, it will be difficult for us to give up the notion of latent downside support as long as index options open interest remains as biased toward puts as it has been.
- 5) *Valuations.* We still find it hard to identify stocks that are cheap, but the erosion in

price of many issues combined with improving earnings and general fundamentals have ground down some of the problematic edge of this factor.

- 6) *The Dollar.* We continue to think that relative currency valuations have receded for now and in coming months as an equity market factor. Euroland is not really meeting its growth goals, and an environment of rising US rates and simultaneous falling or static Euro rates, while novel, isn't inconceivable. Should that come to pass, the dollar would likely strengthen, which would be a flow-of-funds positive for US equity markets, if not for US companies who sell overseas.
- 7) *Mutual Fund cash flows.* Lately those who measure have disagreed on whether mutual fund cash flows are positive or negative, though flows are clearly heading out of bond funds. We can just call this "not a factor" right now, though that can obviously change in a short time. Longer term, fund flows grow as retirement plans grow, so from a broader point of view they remain a support.
- 8) *Earnings.* Profits have been generally in line or better than expectations, which have steadily been rising since the beginning of the year. Comparisons get more difficult as the recovery continues, however, and recently some major retailers, including the large one whose name ends in 'mart,' failed to meet sales expectations despite very buoyant consumer confidence as well as income and spending numbers. Though there aren't enough data points to call it a trend, the seemingly positive environment doesn't point to subpar sales, so one is left to ponder whether there is just too much competition in retail. ISM numbers remain good, though, and a growing economy can cure most corporate common colds.

SELECTED INDICES

	2 nd Qtr'04	12 Mo
S&P 500	1.71	19.10
Equity Inc	0.26	17.32
Util Fund	0.60	13.27
DJU	(0.25)	14.96
LB Long	(5.22)	(3.97)
LBGC	(3.17)	(0.72)
S&P 400	0.97	28.00
Wilshire 5K	1.35	21.24
Rus 2000	0.47	33.37

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

- 9) *There are hidden taxes.* As we've noted, we don't think there was much stimulus, at least at the consumer level, from the recent round of tax cuts: those funds were transferred to the Saudis and the global energy industry through higher oil and gas prices. Accelerated depreciation no doubt prompted corporations to spend more, though these provisions are sunseting this year. We continue to think energy prices will remain high, and it also appears that local real estate taxes are rising everywhere. Could all this new home construction be stressing out the local infrastructure?
- 10) *Insiders are staying home.* We've seen some recent articles alleging that insider buying has improved relative to previous levels of buying as well as compared to insider selling. We don't see any evidence of a meaningful change, and this flag remains red.

In sum, we're about where we were last quarter in our evaluation of the market. The forces conflict, the uncertainties abound, the upcoming quarter has greater potential for downside than up, but what might actualize that potential is at this point even more obscure and occult than it usually is, for global issues and terrorism are in our homes now as never before.

We do think that interest rates are unlikely to be as punitive as they were this past quarter. If they are, they will violate The Law: what nearly everyone expects and what nearly everyone is afraid of is the least likely outcome in the market. □

Disclosure, Yield-Oriented Portfolios: *Gross of fees performance is based on actual results according to the Association for Investment Management and Research (AIMR) standards. MHI has prepared all performance results. AIMR was not involved in any preparation or reporting. 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 firm's 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.*

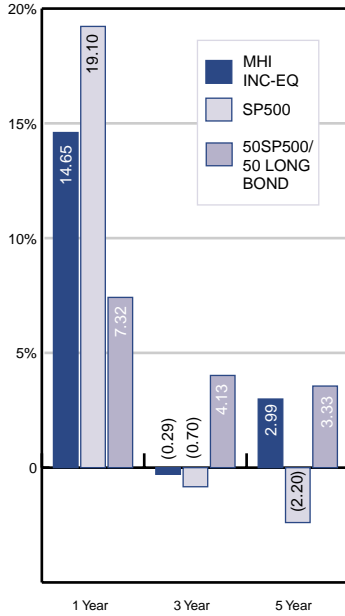
Our Income-Equity strategy had a quiet second quarter, finishing fractionally down for the period and modestly up year-to-date. While it may seem odd, we're quite satisfied with the boring nature of this strategy as well as with the behavior of our individual holdings in the face of uncertain equity markets and, most impressively, during the worst slide in Treasury bond markets since the early 80s. The general perception that high-yield stocks are interest sensitive proved wrong yet again, as dividend and value factors effectively served to dampen the overall volatility of the portfolio while providing investors with a constant and growing income stream.

PORTFOLIO HIGHLIGHTS

Our rejection of REITs on valuation grounds finally paid off, as the widely followed Morgan Stanley REIT Index collapsed in early April suffering the largest monthly decline in its 9-year history. The selloff came at a time when the fear of rising rates converged with unsustainable valuation levels of most of the publicly traded REITs, prompting a mass exodus from the sector by interest rate-sensitive investors. Our only pure equity REIT, Urstadt Biddle Properties, suffered along with the rest of the sector finishing the quarter down (-10%.) But we continue to like UBA, in contradistinction to its peers, as the company continues to trade at a substantial discount to the net asset value of its extremely attractive grocery store-anchored properties in the upscale northeastern US. In reality, higher rates are not necessarily bad for the industry, and could even be desirable for some sectors of the real estate market. In particular, we're

"The general perception that high-yield stocks are interest sensitive proved wrong yet again...."

**Annualized Returns
as of June 30, 2004**



Quarter Composite Net of Fees*

Income-Equity (Prelim)	(0.55)%
50/50 SP500 & Long Gov	(1.79)%

12-Month Composite Net of Fees*

Income-Equity (Prelim)	14.65%
50/50 SP500 & Long Gov	7.32%

5-Year Composite Net of Fees*

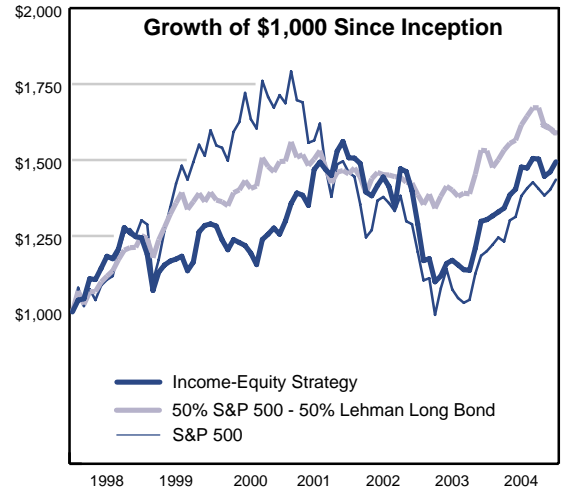
Income-Equity (Prelim)	2.99%
50/50 SP500 & Long Gov	3.33%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 6/30/04: 223 accounts in composite, representing 78% of total assets in the strategy with a dispersion of 0.12. Inception: 5/97.

starting to look closely at the macro landscape of recently underperforming office and multi-family groups. Our reasoning here isn't novel: new job creation will require higher rates of space absorption thus benefiting the office group, while apartment REITs are likely to see a gradual earnings recovery as home ownership becomes more expensive.

Interest rate fever dented our MLP group early in the quarter as well, prompting a broad and indiscriminate selloff across the whole universe, dragging our positions down 5% on average. Some Wall Street analysts attempt to value MLPs using a spread-to-Treasuries metric, which dubiously implies an inherent sensitivity of this asset class to rate fluctuations. While interest rate spreads might be one factor in evaluating MLPs, there are many more, including asset growth, asset valuation, income and distribution growth, takeover attractiveness, etc. Indeed, the record has shown, to the contrary, that MLPs which increase their distributions aggressively do not correlate with bond price movements at all. MLPs are significantly leveraged in a positive way to economic growth, and we think they're among the most attractive groups across the broad market right now.

Financials had a rather mixed quarter on lingering concerns of rising interest rates as well. It could be argued, though, that at least some banks will benefit from an increase in rates as long as it is gradual, the yield curve remains steep, and any increases are accompanied with stronger economic growth. The low rate environment weighs heavily on bank margins as deposit rates are reaching natural floors. As rates gradually rise, most banks expect to be able to lag the repricing of deposits to the repricing of assets leading to margin expansion. In fact, most of our holdings' balance sheets appear to be either interest rate neutral or slightly asset sensitive, which means



that earnings should benefit in a rising rate environment. In addition, M&A activity continues to be strong, with several dozen deals announced just in the past three months and plenty of them in the super regional/commercial space. Wachovia's acquisition of SouthTrust Corp. and SunTrust's purchase of National Commerce Financial, just to name a few, continue to provide a supportive environment for domestic names in our portfolio. M&A activity seems to be picking up overseas as well, following a recent deal involving the Royal Bank of Scotland and Charter One and continuous rumors regarding Abbey National's "shopping list." In fact, we're hopeful that our purchase of ING Groep early in the year (up 7.5% for the quarter) will stand to benefit from European consolidation, in addition to its attractive valuation and a current yield of over 5%.

Our Property/Casualty representation continues to await the pending asbestos resolution, while providing attractive income and diversification benefits. Chubb, given its solid balance sheet, attractive valuation and fundamentals, should enjoy significant growth of earnings and return on equity next year, while continuing to throw off attractive income on a quarterly basis. St. Paul Travelers convertible preferred continues to be the cheapest large cap name in the group, and is likely to generate impressive earnings growth

over the next several years, due to significant cost savings and synergies generated by a recent acquisition of Travelers. UnumProvident convertible preferred (up 6% for the quarter), while still facing real challenges following a credit downgrade in May, remains a high probability takeover candidate (despite a substandard credit rating) in addition to offering a high current yield.

The bulk of positive returns this quarter came from our diversified package of stocks, with R. R. Donnelley, a commercial printing and information services company we reintroduced to our portfolios back in February, leading the quarter up over 9% on solid fundamentals and increased order flow fuelled by economic recovery. After trimming Worthington in April, we continue to monitor developments in the sector and will be reducing our exposure further should WOR's valuation catch up to the rest of the group. For now, trading at 15x earnings, Worthington (up 7% for the quarter) continues to be valued near the lower range of its historical valuation supported by exceptionally strong earnings, favorable commodity pricing and a strengthening economy. Corporate bond spreads, a powerful indicator for this name, continue to remain stable and low, in addition to recent tremendous technical strength and an attractive yield of over 3%.

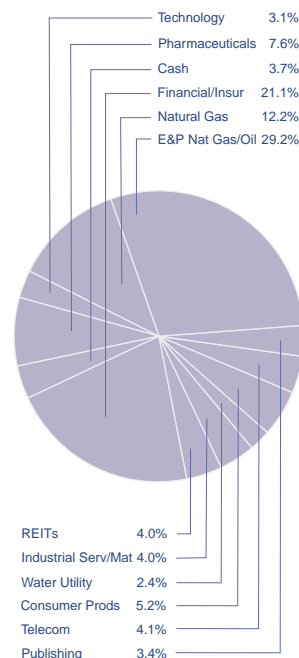
Pharmaceuticals performed reasonably well, with Baxter 7% convertible preferred leading for the quarter (up 5.5% before dividends). We especially like the yield this instrument offers, as well as the convert's negative correlation to Long Bonds and the S&P 500 – a highly desirable risk profile in the current environment. In June we added Bristol Myers to the mix, a quality brand name with an attractive yield of 4.6% and an equally appealing turnaround potential. Bristol's partnership with ImClone and a recent

promising study on the advantages of Erbitux for the treatment of advanced colon cancer make this position especially attractive. In addition to other initiatives, BMY is currently working with Merck (in our portfolios since January and up 7.5% for the quarter) on a Phase III drug used for the treatment of diabetes, which is likely to benefit both names. Bristol's focus on specialty products combined with Merck's significant presence in the primary care business, low valuation, high dividend yield and an under-appreciated pipeline, make these two positions highly complementary to each other and add attractive diversification and growth prospects to the overall portfolio mix.

Other notable events this past quarter include our continued search for "special dividends" that we started in the beginning of the year through our purchase of Anixter International for its one-time dividend of \$1.50. Following a similar strategy, in April we added Ethan Allen Interiors for the extra dividend payment of \$3.00 per share. While we've been paid and moved on from both of these names, we will continue to search for similarly attractive opportunities going forward.

LOOKING FORWARD

After a decade of ignoring deep investment basics, the marketplace once again sees the appeal of yield in equity investments, especially in the face of rising interest rates. Based on a time-tested approach to wealth creation through income, stability and moderate growth, our Income-Equity Strategy continues to exhibit steady strength in a very "unsteady" market environment. It features: A- average equity financial strength, low beta to the broad market and a lack of correlation with Long Bonds, industry diversity, modest valuation metrics, and a current yield of almost 6%, along with projected dividend growth of 4%. □



FUNDAMENTAL CHARACTERISTICS

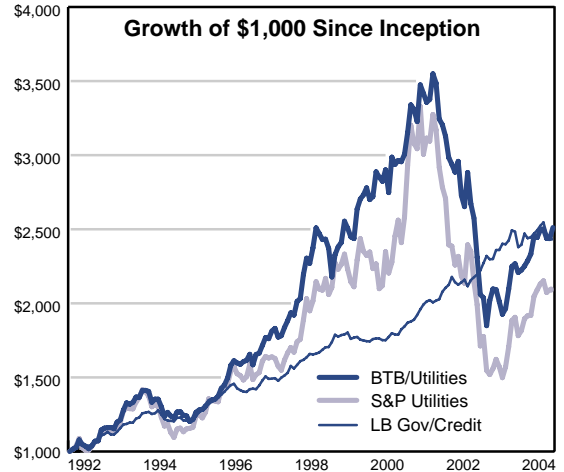
Yield	5.8%
Proj Dividend Growth	4.4%
Payout Ratio	61%
Market Cap (MDN)	\$5.4 Bil
Price/Book	2.6
P/E Ratio** (MDN)	14.2
S&P Rating	A-
Beta*	0.54
Standard Deviation	12.87

*Relative to S&P 500, 6/30/99 - 6/30/04

**REITs use P/FFO ratio

".....high natural gas prices played a very significant role in this quarter's performance, and we expect they will continue to do so until the end of the decade."

We had a profitable quarter, even as the 10-year Treasury yield soared more than 75bps, and the two most widely referenced utilities benchmarks declined – Dow Jones Utilities (-1.14%) and S&P Utilities (-2.27%). Most of our portfolio's alpha came from our pure-play E&P gas producers and diversified utilities with natural gas production. Since we've been forecasting (admittedly ad nauseum) a new paradigm for natural gas prices in response to North American fundamental supply/demand tightness, we're pleased that our early positioning of the portfolio for sustained high natural gas prices has really started to pay off. Our more traditional electric and gas utilities lagged in performance this quarter, more in line with the general utilities universe, but still weren't especially problematic. Indeed, these have begun to look increasingly attractive on our valuation measures.



PORTFOLIO HIGHLIGHTS

As noted above, high natural gas prices played a very significant role in this quarter's performance, and we expect they will continue to do so until the end of the decade. As the nation's newly built fleet of natural gas-fired electric power plants comes online this Summer to meet "normal" air-conditioning demand, there is a good chance that most consumers and public policymakers will be shocked by the accelerated rate of gas consumption from these plants. With a hotter-than-normal Summer forecast for much of the population, we wouldn't be surprised to see price spikes sufficient to send politicians into an apoplectic fit, prompting investigations into the usual suspect: "market manipulation."

Unfortunately for natural gas consumers, the die was cast nearly twenty years ago, when the nation committed itself to electric generation and home-heating by "plentiful and cheap" natural gas. But the level of natural gas production in North America has flattened out and possibly declined. Demand (heating, industrial, electricity generation) continues to

Quarter Composite Net of Fees*

BTB/Util (Preliminary)	0.63%
S&P Utilities	(1.31)%
LBGC	(3.17)%

12-Month Composite Net of Fees*

BTB/Util (Preliminary)	11.01%
S&P Utilities	11.44%
LBGC	(0.72)%

10-Year Composite Net of Fees*

BTB/Util (Preliminary)	7.44%
S&P Utilities	6.85%
LBGC	7.43%

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 6/30/04: 153 accounts representing 95% of assets in the strategy, with a dispersion of 0.13. Inception: 9/91. History includes one institutional client, 45% of the composite, that held a 2% position not held by others in the composite.

CHANGE IN BENCHMARK

Please note that we've changed our benchmark for the BTB/Utilities portfolio: from now on, we'll be using the S&P Utilities as our benchmark, rather than the Dow Jones Utilities. The reasons for this change are twofold: (1) the DJU is comprised of only 15 utilities, while the S&P Utilities is comprised of 30 utilities – the larger S&P Utilities index is more representative of the broad utilities sector, and (2) the DJU includes 4 companies with "junk" credit ratings and/or bankrupt, which actually accounted for more than half the DJU return last year. There is a place in this world for speculation in stocks such as those that juiced the DJU last year, just not in our portfolio, and we think comparison with a more moderate or diverse list is appropriate.

grow, but supply has not. Relief via Liquefied Natural Gas is many years away, and there is considerable resistance in many locations to constructing LNG terminals, for safety reasons. Though prices will always fluctuate some, there is simply no reason right now to think that gas prices will back off. Six-dollar gas in summer! It's beyond a record!

Our pure-play E&P companies posted the strongest showing this quarter: EOG Resources (+30.12%), Burlington Resources (+13.72%), Devon Energy (+13.50%), Anadarko Petroleum (+13.00%), and new addition Pioneer Resources (+6.97%). PXD, a very well-managed company with an impressive track record of organic reserve and production growth through the drill-bit, was added to the portfolio shortly before it announced its acquisition of another outstanding E&P company, Evergreen Resources. This newly combined company is a drilling powerhouse, with outstanding prospects ahead. We're feeling pretty good about replacing our telecom exposure with these gas stocks, since the RBOC's were down this quarter.

Natural gas distribution utilities with gas production subsidiaries also had another standout quarter: Equitable Resources gained 16.41% while also raising its dividend by 27%, Southern Union gained 11.24% as it continued with plans to expand its crown jewel Lake Charles LNG facility, Questar gained 6.04% and raised its dividend by 5%, aided by rising demand for its gas and gas transportation pipelines in the far West.

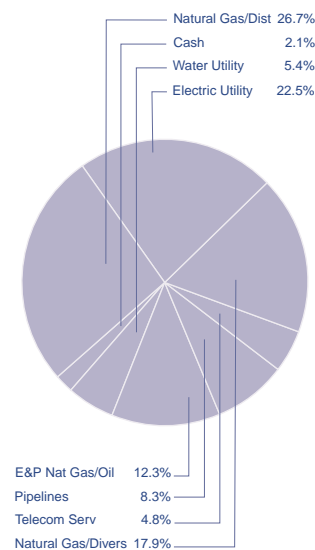
We added some Gulfterra Energy Partners this quarter (current yield 7.3%), a Master Limited Partnership soon to be acquired by another MLP, Enterprise Products Partners. Their merger with EPD should provide a nice

balance of business risks, since EPD has little commodity price exposure and strong credit, while GTM owns critical pipeline assets serving several natural gas producing growth regions – including the Gulf of Mexico and the Rockies, and has suffered lingering credit weakness following their divorce from El Paso Corp. This merger will create a balanced titan.

PEPCO continues to suffer from worries that a federal court will decide to release bankrupt Mirant from its contract to provide POM with low-cost electricity, thereby forcing POM to purchase power on the spot market. We don't share this concern, and believe that POM is a steal here trading at 1.0x book value.

LOOKING FORWARD

We're pleased with our balance of conservative, regulated utilities that steadily increase their dividends and our diversified utilities that have exposure to rising gas prices. Further, our growth kickers – large, financially strong, low-cost, pure-play natural gas E&P companies – are working out well, with significant upside potential if gas prices remain high. With earnings for our conservative utilities likely to benefit from the improving economy and forecasted hot, sticky weather, we believe that steady dividend increases will insulate our utilities from any interest-rate induced malaise. And with bonds likely to extend their worst quarterly performance since 1980 as rates continue to creep up, our nearly 4% current yield with 4% projected growth of yield looks better and better. □



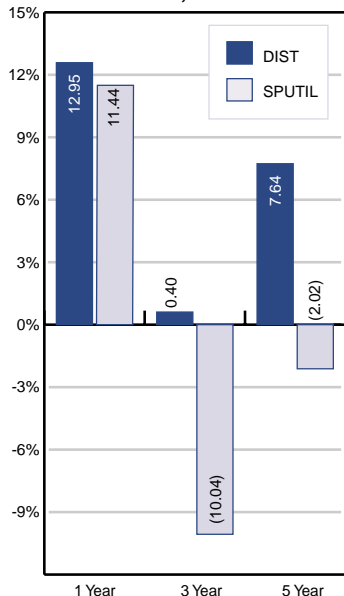
FUNDAMENTAL CHARACTERISTICS

Yield	3.9%
Proj Dividend Growth	4.5%
Payout Ratio	51.4%
Market Cap (MDN)	\$3.2 Bil
Price/Book	1.8
P/E Ratio (MDN)	14.8
S&P Rating	A-
Beta*	0.62
Standard Deviation	15.67

*Relative to S&P500, 6/30/94 - 6/30/04

Nothing much happened this quarter, and our flat performance speaks to this. We're pleased that in the absence of any significant news or legislation we beat the popular utilities benchmarks (S&P Utilities and DJU), though prospects for a repeal of the Public Utility Holding Company Act have temporarily dimmed in the run-up to this November's Presidential election. Nevertheless, our assortment of steady-eddy regulated utilities continue to pay their dividends (current yield of 3.74%) and await an acceleration in economically driven demand, a transaction within the PUHCA regime (a la Unisource or Portland General), or, perchance, a political sea change following our next great blackout! In any case, our utilities continue to trade at attractive valuations with solid appreciation potential from here – while representing, we think, all of the best, conservative takeover candidates.

Annualized Returns as of June 30, 2004



Quarter Composite Net of Fees*

Distribution (Prelim)	(0.24)%
DJUA (total return)	(0.25)%
S&P Utilities	(1.31)%

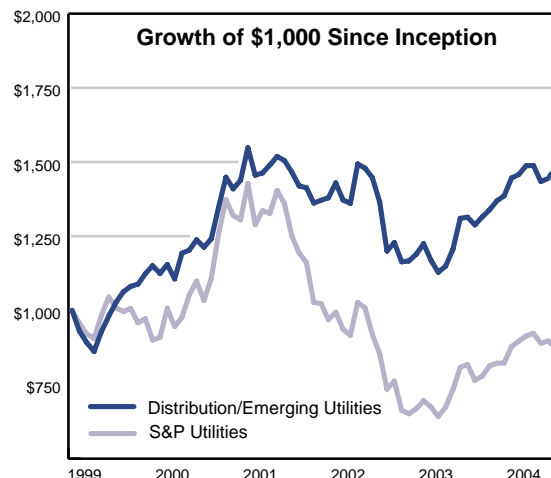
1-Year Composite Net of Fees*

Distribution (Prelim)	12.95%
DJUA (total return)	14.96%
S&P Utilities	11.44%

5-Year Composite Net of Fees*

Distribution (Prelim)	7.64%
DJUA (total return)	1.34%
S&P Utilities	(2.02)%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 6/30/04: 111 accounts, representing 91% of total assets managed in the strategy with a dispersion of 0.28. Inception: 12/98.



CHANGE IN BENCHMARK

We've become somewhat disillusioned with the Dow Jones Utilities as our benchmark, and have decided to employ the S&P Utilities going forward. Please see our discussion of this change in our Better Than Bonds/Utilities write-up on page 6.

PORTFOLIO HIGHLIGHTS

As noted in our BTB/Utilities discussion, utilities with natural gas production fared best this quarter, as natural gas prices set new seasonal records and will likely continue to trade near record-setting levels for several years to come. Our best position for the quarter was Energen

Corp (+16.34%), an Alabama natural gas distributor with significant natural gas production assets, and an appetite for expanded drilling and production of low-cost, long-life reserves. EGN's CEO also happens to be the American Gas Association's former Chairman, so they know gas! Southern Union was our next best performer (+11.24%), a multi-state gas distributor that is in the process of expanding their Lake Charles LNG terminal to capture additional volumes of "cheap," imported gas ... and recently surfaced as an 11th hour bidder for Enron's extensive pipeline assets in bankruptcy. Sempra Energy (+8.27%), the largest regulated natural gas distributor in the country continues to lead the race to build new LNG terminals in the United States and in Mexico's Baja peninsula. SRE's business model of expansion into the unregulated – though relatively conservative, long-term contract – business of operating LNG terminals that serve (1) the needs of their regulated system, (2) high-credit LT contracted parties, and (3) spot market demand for excess gas capacity may signal a new and innovative direction for large gas distributors. SRE is well ahead of the pack.

This quarter, several of our holdings increased their dividends – which remains an important element of this strategy while we wait for a transaction – including: Xcel Energy, ONEOK, Northeast Utilities, and Questar Corp by 10.7%, 9.5%, 8.3%, and 5% respectively. PNM Resources, a New Mexico regulated utility with modest ventures in low-cost merchant power and wind, concluded a 3:2 stock split, and gained 3.68% for the quarter.

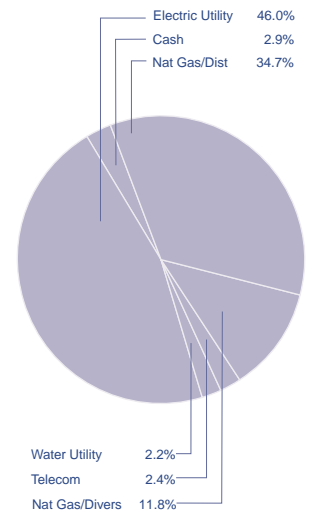
While many of our holdings meandered sideways during the quarter along with the broader universe of utilities, a few positions fell under company specific pressure. PEPCO Holdings, the regulated plain-Jane distributor serving Washington, DC and Maryland, continued to languish from concerns that its electricity contracts with bankrupt Mirant will be cancelled in court ... and this interesting and important question is now being appealed in the Federal Courts. With FERC having intervened on behalf of POM and conflicting precedents having been set in US District Courts, this case will probably make its way to the Supreme Court. Still, we're not too concerned about the outcome, since POM is trading at book value and will ultimately be made whole by its customers – which include the Federal Government! TECO Energy of Tampa, Florida, still suffers from overleverage and cannot seem to sell its non-core assets fast enough to please investors. Still, this utility enjoys fantastic demographic growth, friendly regulators, no debt maturities until 2007, and is currently trading below book value. We view TE as an attractive and likely target for one of its 800-pound neighbors (SO, PGN, and FPL). NUI also came under pressure this quarter as their efforts to sell the company were held

hostage to an investigation by the NJ State Attorney General into NUI's wholesale energy trading subsidiary. Thankfully, that investigation just concluded with a settlement that shouldn't have a material impact on NUI's liquidity, and now clears the way for a transaction. The company has hinted that they have a buyer waiting in the wings, and expect to sign a definitive agreement in the 3rd Quarter.

LOOKING FORWARD

With PUHCA repeal on hold until after November, we can take heart in signs of a genuine economic expansion that translates into increased demand for basic services. Also, dire forecasts for a hot, sticky Summer across much of the densely populated US – which is where our companies are concentrated – augers well for higher-than-normal service demand and greater consumption of natural gas. So, start your air conditioners! With our balanced portfolio of staid, financially strong distribution companies, a few small weights in moderately distressed regulated companies trading at significant discounts, and exposure to rising gas prices through diversified utilities with production, we believe this portfolio is positioned to appreciate while we wait for the commencement of takeover transactions. In the meanwhile, we'll continue to collect our rising dividends. □

Note: We'll be sending our Alpha-Based Strategy report directly to clients of the strategy this quarter. It is also available on our website at www.mhinvest.com, along with numerous articles on dividend-oriented investing and the utilities industry.



FUNDAMENTAL CHARACTERISTICS

Yield	3.7%
Proj Dividend Growth	3%
Payout Ratio	59.5%
Market Cap (MDN)	\$2.3 Bil
Price/Book	1.5
P/E Ratio (MDN)	14.8
S&P Rating	BBB+
Beta*	0.35
Standard Deviation	13.65

*Relative to S&P 500, 6/30/99 - 6/30/04

".....dividend-paying stocks outperform the average stock, and stocks with rising dividends have, in most periods, ranked among the highest performers."

As investors view a horizon which may include multi-year increases in interest rates combined with significantly reduced expectations regarding growth stock performance (and those two items are not unrelated), there has been a notable return among market strategists and in the media toward time-tested classic approaches of investing. Among the foremost elements of classic investing is the demand for dividends.

Through the years there have been numerous academic studies which have consistently shown that dividend-paying stocks outperform the average stock, and stocks with rising dividends have, in most periods, ranked among the highest performers. Since the long-term superior performance of stocks over bonds is almost an investment given, we wonder why dividend-oriented investing ever fell out of favor at all?

Rather than answer that question, which would involve a deep journey into human character and motivation, we thought we would share some studies and insights into the comparison of dividend stocks with bonds, and with stocks in general, that have recently crossed our desk.

Sungard strategist Gail Dudak noted in 2002, after and during some of the (many!) accounting scandals, "Only companies with real cash flow and real earnings will consistently pay dividends to investors! Dividends are a financial commitment from a company. They cannot be paid with smoke and mirrors." She goes on to tabulate over 200 years of returns from stocks, concluding that "In 13 of the 20 decades, reinvested dividend returns represented an average of 57% of the total return seen over the course of each decade... An important side benefit of high-yield stocks is the protection the dividend provides in a weak stock-market environment. This will also be rediscovered by the new generation of investors..."

While Dudak is correct about the proportion of returns attributable to dividends and the re-investment of dividends for each decade, she really doesn't go far enough in evaluating the impact of dividends on total returns over the rather longer periods that comprise most individual investors life expectancy, nor the infinite life expectancy of an institution such as an endowment, foundation, or defined benefit pension fund.

The longer the time period, the greater the impact of reinvested dividends on total return. (This is largely due to the fact that dividends are always buying more shares, creating a compounding dynamic. Each share purchased at the beginning of a decade, for example, might become two to four shares by the end of the decade, depending on the level of income and the course of prices. The greater number shares produces, obviously, a greater effect from changes in equity prices, since it is a multiplier).

In a recent article in *PlanSponsor*, William Raver, investment director for Verizon

Income Percentage of Total Return*					
Length of Rolling Period	US Equity	US Real Estate	US Fixed Income	UK Equity	UK Fixed
5 years	43.0%	77.0%	97.0%	48.0%	91.0%
10 years	50.0%	81.0%	99.0%	55.0%	94.0%
20 years	63.0%	86.0%	103.0%	68.0%	98.0%
78 years	96.2%	99.5%	99.8%	97.7%	99.7%

*Note: Rolling returns are annualized returns for a series of overlapping, smaller time periods within a single, larger time period. For example, the 20-year time period from 12/31/82 through 12/31/02 consists of 16 five-year segments. The first segment is the five-year period 12/31/82-12/31/87, the next segment is the five-year period 12/31/83-12/31/88, and so on.

Source: Brandes Institute, as of January 31, 2004

Communications, wrote on “Recognizing the Value Of Current Income.” Working with the Brandes Institute, he revisited the work of Professor Elroy Dimson of the London Business School—who has further studied and amplified the conclusions of Roger Ibbotson of Yale, that “the current income stream from both equity and fixed income securities, when reinvested, forms the predominant share of long-term reported returns.” Raver points out that, on average, after *ten* years the percentage of income attributable to income and its re-investment is greater than 50%; the value of the income at that point exceeds the value of changes in the asset price of equities. After *78 years*—the period covered by Ibbotson—the proportion rises to 96.2% of total return attributable to the dividend portion! Try asking even sophisticated investment professionals what the very long-term contribution of income to equity total return is—you’ll not likely hear the right answer. As one might expect, the contribution of income to fixed-income total return is about 100% over the long term.

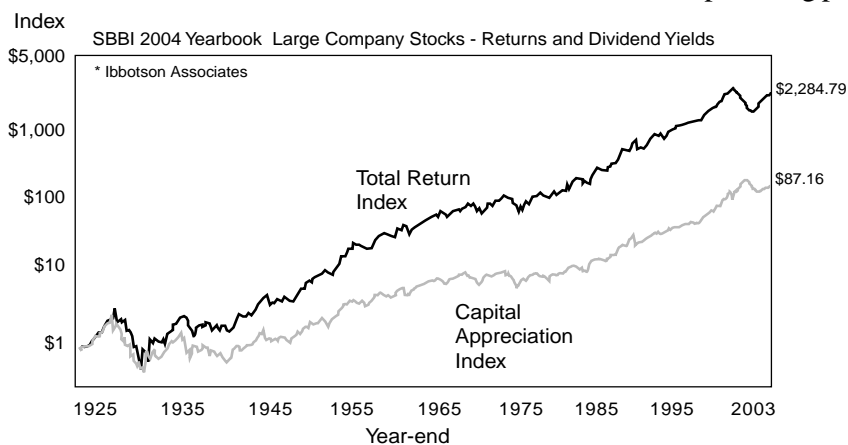
Raver talks about the difficulty managers have in delivering value-added performance: “One obvious example is a portfolio whose current yield regularly carries a lower current yield than the market benchmark against which

performance is being measured. This effectively raises the “alpha hurdle” for the product—often by as much as 50-100 basis points in an environment where three- and five-year expected excess return is only 150-200 basis points. Why active managers want to handicap themselves like this has always puzzled me, especially in the context of the long-term importance of current income to total return...”

In our view, the same thinking may be applied to investors of all kinds. Fancy asset allocations and pie charts decorate presentations filled with total return expectations. Investors get some growth, some value, some large, some small, and it all makes them feel like they own a fully furnished house. But what about the fact that history, over decades and centuries, shows us that the compounded *income* from investing—not style, not sector, not asset classes, but *income*—is the true driver of long-term total returns?

Investing for income from equities is great if you have a spending need and want to avoid invading principal, particularly when markets are down, and especially if you would like your income to increase over the years. But those whose investment goal is total return for the long term should emphasize income, too, since they receive an even bigger benefit from the re-investment and compounding process. □

“Dividends are a financial commitment from a company. They cannot be paid with smoke and mirrors.”



WHAT THEY'RE SAYING...

“The higher that interest rates go, the less you’re willing to pay for the future,” Mr. Dreman said. “So my thought is, the Nasdaq, the tech sector, the dot-coms and other fast-growing segments of the market may have problems with P/E compression.”

David Dreman, Chairman of Dreman Value Management

“People are plowing money into emerging-market debt and equity funds, and ignoring the fact that they could get 4 percent dividends on a U.S. food company,” Richard Bernstein, chief US strategist at Merrill Lynch. Investors often place too much emphasis on capital appreciation, he said, and too little on income.”

New York Times, March 7, 2004

“Earnings are very difficult to estimate....cash dividends are not.”

Alan Greenspan

“Master limited partnerships may be less sensitive to rising interest rates than other high-yield investments, like junk bonds and REITs (real estate investment trusts), says Ron Londe, analyst with A.G. Edwards in St. Louis. “They also offer the potential for distribution increases, which can offset weakness from rising interest rates. MLPs have been increasing distributions at around 6% per year, faster than the inflation rate, and this is likely to continue.”

Financial-Planning.com, June 2004

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