Miller/Howard
INVESTMENTS, INC

MARKET OVERVIEW

That the market was characterized by a tight trading range with a mostly downside bias was no surprise to us, nor was it, we hope, to regular readers of this quarterly. That bonds rose rather than continue their wrenching behavior of the second quarter was also not surprising (we cited The Law last time, that "what nearly everyone expects and what nearly everyone is afraid of is the least likely outcome in the market), though the magnitude of bond gains was somewhat astonishing. What surprised us was the reaction of the bond market to gains in energy prices. We must be too old! We always thought that record high oil prices (and record high natural gas prices for summer) were inflationary and that bond investors would be leery of an environment with such a fungible inflationary input.

"Not just now," opined the pundits and experts. "Energy plays much less of a role in the economy now than it did in the 1970's and 1980's, and there's no inflation in sight." Bond market investors (or is it now hedge-fund carry-traders?) took heed, and stood the time-tested relationship between energy and bonds on its head: rising energy prices are now perceived as a damper on economic activity, therefore higher oil costs induce lower interest rates. The Bubble's magic incantation has arisen in a new connection, as the market's vocalizers chant again: "this time it's different!"

We can only imagine that those who sincerely believe raging energy prices are disinflationary don't drive automobiles and probably live in unheated homes. While in the short term consumers may surely slow down their spending and hand over their tax cuts in order to pay more for survival necessities (not really a big plus for GDP), how long will it be until workers require additional compensation to make up the shortfall, and/or to afford products and services in which energy is a cost factor? Could the world have changed so much? We're probably just too old to understand it.

But we're not too old to understand that dividends are the new new thing! After nearly fifteen years of disdain, suddenly investors and the market strategists who prod them into action have rediscovered the many positive features of dividend-oriented investments. It would be cynical of us to suggest that many newcomers to this way of looking at the world are simply hoping to get something from a future in which for the first time they can imagine getting nothing. In any event, it seems as though there's a new study or article praising the virtues of dividends nearly every week. After years of proselytizing for the benefits of dividends, rising dividends, and the re-investment of dividends to create a long-term

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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"compounding machine," our hearts are warmed by the new sanity which now believes that a merely reasonable return with modest risk is a worthwhile goal.

Dividend stocks have become the hot dot this year and for the past twelve months, for reasons that have been adumbrated here and in the press perhaps a little too frequently in the past couple of quarters (rationales typically arise to illuminate phenomena, rather than the other way around). Normally, that would begin to make us nervous. But we are just now, in the marketplace, emerging from roughly fifteen years of darkness and dividend disdain. A new constituency for dividend stocks is being built from the ground up, and the incipient demographic of retiring baby boomers is likely to only strengthen that groundswell. So until we reach a point of overvaluation, which is hardly close at hand right now, we remain, as we put it last time, content.

"But we are just now...emerging from roughly fifteen years of darkness and dividend disdain."

The broader market continues as a kind of hopelessly marbelized mélange of cross-currents, as it was when we last wrote, with frequent televised beheadings and general terrorist threats serving as a kind of quicksand undermining the investor confidence in the future that would be necessary for a real bull market. The phrase of the day is Soft Patch. The question of the year is whether that phrase is election-year spin or an epochal descriptor.

As was the case last time, our ten points haven't changed much, though in general the "soft patch" zeitgest is reflected in our list:

1) *The Fed*. In September the Fed raised rates another .25% and did not change their evaluation of the economy. Rates remain too low for our comfort, and they are a signpost of the deceleration that is apparent everywhere. We'll be more relaxed about the economy and potential job creation when rates are "normalized," which would mean a doubling or more from here, but we're doubtful about much more rate-raising unless conditions become significantly stronger.
2) *Terrorism.* Let's face it. We in the US, and most of the rest of the world, for that matter, are just waiting for the other shoe to drop. We—as in all of us—don't believe we are winning the war on terrorism. We don't believe the threat is waning. We don't believe the government agencies are capable of stopping all terrorists before they act. We don't even believe the government can identify all terrorists so they can be monitored. We wonder, in a kind of distracted denial, about the safety of our local middle school. The Olympics and the political conventions passed without incident, which is a definite positive, but what about that other shoe?
3) *Traditional sentiment measures* (advisor bullishness, volatility index, short interest, and the like). These measures have made modest improvement as advisor and investor expectations have been blunted by a frustrating market.
4) *Our proprietary options indicator*. There's no signal change in our indicator, though it has drifted toward neutral, while still generally bullish. We've noted that the state of put/call open interest on the indices suggests a modest downside risk, at least, since ongoing option holders continue to be positioned in favor of puts, and that remains the case.
5) *Valuations*. All other things being equal, the longer the current stasis in the market persists, the better valuations become, as companies "catch up" to their stock valuations. Considering where bonds are as of this writing, valuations have come down from high to middling. But the very fact that a bond rally wasn't able to

SELECTED INDICES

	3rd Qtr'04	12 Mo
S&P 500	(1.87)	13.86
Equity Inc	0.62	15.57
Util Fund	5.90	21.11
DJU	7.22	22.24
LB Long	6.36	4.94
LBGC	3.56	3.33
S&P 400	(2.10)	17.56
Wilshire 5K	(1.78)	14.83
Rus 2000	(2.86)	18.77

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

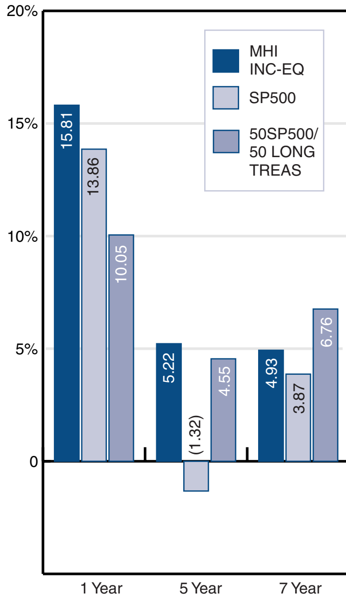
generate interest in stocks implies either than the bond rally will fade, which valuations are anticipating and to which they have already adjusted, or that bond action is telling equity investors the "soft patch" is somewhat bigger than a patch, and best to pay less rather than more for future prospects. This is certainly not the problem it once was, but only if the economy doesn't worsen and inflation isn't real (as should be clear from our earlier comments, we don't think the government statistics present a complete picture of the inflation situation). See #8

6) *The Dollar*. Not much change here, and not much expected for the near term, so not really a factor. Longer term, it's more analogous to the terrorist threat, as the dollar floats like a barge on a river of foreign bank holdings. There could be circumstances—just what, we're unable to articulate right now—in which this changes. It is not a rule that foreign banks have to buy our debt. Look out below if they ever stop.
7) *Mutual Fund cash flows*. Once again, a short term neutral and a long-term positive.
8) *Earnings*. This is getting to be a problem area, at least in view of the information we have available as we write. Clearly, valuations hinge to a large extent on earnings, and so far this quarter there have been more pre-announcements of earnings shortfalls (plus reduced guidance) than at any time since the year 2000. That's not just saying more than at any time in the past four years, that's saying since the year 2000, that year when the music totally stopped! Analyst estimates are starting to come down from early-year optimism across the board. Comparisons become more difficult as the recovery matures, and the recovery isn't even maturing very well now, either. Technology companies are expressing "low visibility" once again. Chip companies are staring sullenly at mountains of inventory. Manufacturers are bugged by steel and energy prices. Health care companies are bugged by everything from cheap import issues to changes in federal reimbursement. Retail sales are off, in general. Consumer product companies are complaining of rising costs. People aren't even drinking that much Coke at this point. We've been somewhat sanguine about earnings prospects. Now, while not alarmed, we're much less so.
9) *Hidden Taxes*. We're about as confident as we ever get that energy prices will remain high, that goods with energy inputs such as cars and other durables will remain pricey, and that local taxes will continue to rise. None of this helps the economy to grow.
10) *Insiders* are staying home. Some commentators in this area suggest the readings are more neutral than they were. We still say insiders are for the most part not interested.

Add it up and you get little change in view. The ISM (purchasing manager) readings continue to show a growing economy, and we have always relied on these purchasing manager surveys as the best information available—though even these numbers are not as strong as they were. It's tough to be very bearish as long as these numbers are adequate and valuations are not outlandish (and they're not). But woe is us if this soft patch should turn into a hard patch.

Much is on hold, in the minds of investors, business owners and executives, and consumers, until after the election. We think it's probably appropriate to put one's opinions in the same place until Nov. 4, at the earliest. ❑

"The phrase of the day is Soft Patch. The question of the year is whether that phrase is election-year spin or an epochal descriptor."



Quarter Composite Net of Fees*

Income-Equity (Prelim) 3.9%

50/50 SP500 & Long Treasv 2.7%

12-Month Composite Net of Fees*

Income-Equity (Prelim) 15.8%

50/50 SP500 & Long Treas 10.1%

5-Year Composite Net of Fees*

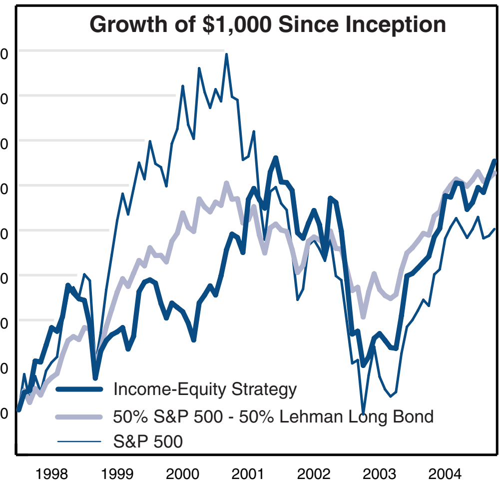
Income-Equity (Prelim) 5.2%

50/50 SP500 & Long Treas 4.5%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 9/30/04: 232 accounts in composite, representing 68% of total assets in the strategy with a dispersion of 0.18. Inception: 5/97.

We had a solid quarter, moving up even as the overall market and most categories had a negative quarter. A "surprise" move down in interest rates (we noted last quarter that rates were unlikely to move higher soon, if for no other reason than that virtually everyone expected them to) no doubt helped, though, as we outlined last quarter, this portfolio doesn't require falling rates to do well. Generally, the groups in which we're most importantly represented did well or not badly, and our individual companies offered a steady stream of positive news with no disappointments.

As we mentioned in the Overview, excess performance of our stocks combined with an excess of praise in the press and from investment strategists raises an issue of whether the current run is overdone. We don't think so: our valuations remain well below those of the broad market as well as historic valuations for our group, and income remains well above the yields available from competitive fixed income instruments. Indeed, our yield is fairly close to the levels offered in junk bonds now, yet our portfolio sports an average credit rating of A-/BBB+. While, paradoxically, good returns can be a discomfiting success, we need to remember that solid yield-oriented investing has been out-of-favor for nearly fifteen years (despite the fact that over longer time periods it is the most classic style of investing), so there is a long way to go before we would detect anything resembling froth. Too, while excess performance has been large, absolute performance is still in mid-single-digits for the year—not so great as to induce a vertiginous response.



PORTFOLIO HIGHLIGHTS

Last quarter we suggested that investors had erred in selling off MLPs, that this group offered an ideal combination of yield and growth in a sustainable model, and that they would likely lead the portfolio this quarter. This was in fact the case, as our MLP section led the portfolio higher, with mostly double-digit gains; the individual issues mostly finished at or near all-time highs. Though we would debate Street analysts who suggest that the stocks are highly interest-rate sensitive, it has been true this year that, like REITs, they've behaved at least coincidentally in tandem with rates. This characteristic might be repeated until the consistency of their growth trumps interest rate considerations in the minds of analysts who tend to draw big conclusions from little data, but in the long run we're convinced they'll be perceived as growth instruments as well as yield vehicles.

ONEOK confirmed our view at the direct business level by acquiring the general partner interest in Northern Border Partners (we hold both issues), stepping into shoes designed by

Kinder Morgan, Inc. OKE has a significant inventory of properties which could be acquired by NBP, giving the latter's partners a growing stream of income and giving OKE a higher net cash flow from its mature properties in addition to balance sheet improvement.

Elsewhere, Community Bancorp was added to the S&P Smallcap index, inducing a bump up in its stock and reminding investors to look again at the success of the company—CBU increased its dividend 12.5% in August. Two of our favorite utility distribution takeover ideas, Nicor and Energy East also did well, as did our bank takeovers Keycorp and US Bancorp. Worthington rode the overall strength in the steel market to a good gain, and BP benefited from higher energy prices to rise over 7% for the quarter.

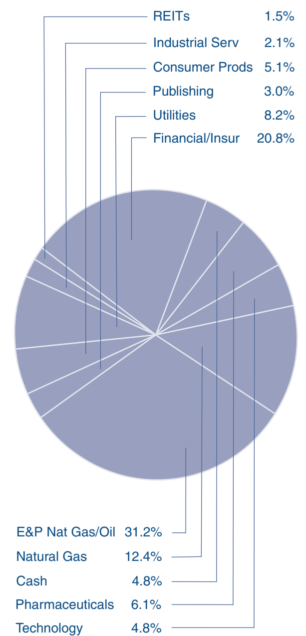
On the downside, a number of our "mainstream" stocks showed small losses as the mainstream dried to a trickle; Conagara, Donnelly, Baxter, GM, Microsoft—were all clouded more by generalized market weakness than by any company-specific issues. GM did show soft sales, but rebounded smartly in its September figures. Merck was the real bummer in the portfolio, costing 90 basis points (.9%) of portfolio return. The company provided a serious negative surprise on the last day of the quarter, announcing that it was withdrawing Vioxx from the market due to side effects that were observed in patients who had used the drug for more than 18 months. We think the initial selloff was overdone, as a 13% decline in revenues was greeted by a nearly 30% decline in the stock, but nevertheless this news is substantial. To be sure, the stock was cheap before the decline and is now still modestly priced even given its changed prospects. The yield is high and safe. Some say merger prospects have been boosted. But in the absence of an imminent drug breakthrough, which doesn't appear to be in the offing, our current thought is that MRK will be dead money at best, risky at worst, once it bounces back to correct the panic selling of Sept. 30. We're looking to make a graceful exit in the absence of intervening news that would prompt a change of heart.

LOOKING FORWARD

We don't expect much change in the macro-economic picture in the visible future, nor do we expect investors to suddenly turn away from the yield-oriented segment of the market that has been one of the few warm redoubts this year. Clearly the elections will have an influence, but, sorry to say, we're not clear about what that influence will be on stock prices. This is still a post-bubble environment. We can't remember a time when the line between inflation and deflation, the line between good economy and bad economy, was so thin. Better to stay with the reliable steady-eddies!

Current income yield from the portfolio is 5.8% ❑

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.*



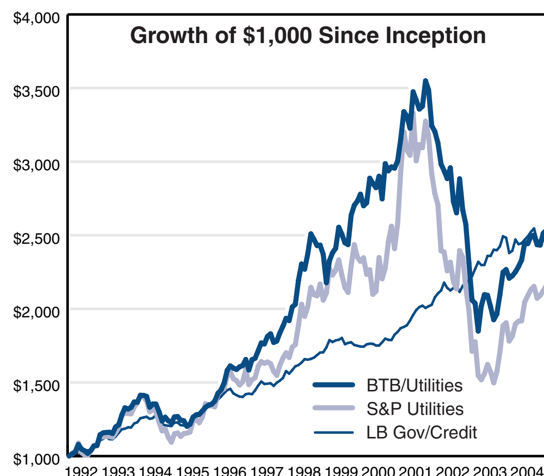
FUNDAMENTAL CHARACTERISTICS

Yield	5.7%
Proj Dividend Growth	4.0%
Payout Ratio	54%
Market Cap (MDN)	$5.6 Bil
Price/Book	2.5
P/E Ratio(MDN)**	14.0
S&P Rating	A-
Beta*	0.5
Standard Deviation	12.9

**Relative to S&P 500, 9/30/99 - 9/30/04*
***REITs use P/FFO ratio*

"...utilities are a unique asset class that does not necessarily correlate to anything— but that does perpetually benefit from serving the eternal and inelastic market for essential services here and around the world."

This was a big quarter for us, lending a little credibility to the idea that utilities' move to a "back to basics" philosophy has gained traction both in their business models and among investors, and lending credibility as well to the notion that utilities are an equity asset class with high yield whose performance does not necessarily correlate with movements in the broader markets. Having seen earlier in the year and last year that utility performance does not necessarily correlate with interest rates, we hope the inner arguments of investors have been calmed, and that many more have come to see, as we have, that utilities are a unique asset class that does not necessarily correlate to anything— but that does perpetually benefit from serving the eternal and inelastic market for essential services here and around the world.



Quarter Composite Net of Fees*	
BTB/Util (Preliminary)	7.6%
S&P Utilities	6.7%
LBGC	3.6%

12-Month Composite Net of Fees*	
BTB/Util (Preliminary)	20.2%
S&P Utilities	19.5%
LBGC	3.3%

10-Year Composite Net of Fees*	
BTB/Util (Preliminary)	8.1%
S&P Utilities	7.2%
LBGC	7.7%

Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 9/30/04: 151accounts representing 95% of assets in the strategy, with a dispersion of 0.26. Inception: 9/91. History includes one institutional client, 45% of the composite, that held a 2% position not held by others in the composite.

PORTFOLIO HIGHLIGHTS

In early 2003 we replaced the majority of our telecom exposure with natural gas producers, in the more aggressive area of our portfolio. Our thoughts were as follows: telecom companies have been rocked by competitive forces hitherto unknown, and faced a future of continued competition within the industry, and perhaps even more difficult competition from cable and the disruptive new technology of VOIP (voice over internet, or converged digital voice and data). We thought the large incumbents had a chance to win in VOIP implementations, but it would prove to be yet another way for them to generate decreasing margins. While the Baby Bells remained financially strong, offered good yields, and are still in possession of the majority of their previous franchises, going forward we saw them more as potential trades during periods of extreme pessimism than as the kind of solid long-term holdings they once had been. At the same time we had begun to see (and discuss in 2002 quarterlies) that natural gas—which is the fuel for all of the new electric generation built in the past five years (making natural gas a kind of functional equivalent of light, just as it provided light 100 years ago!)—was entering a period of chronic shortage. While abnormal weather has masked even stronger potential demand for gas, commodity prices have doubled and tripled since then. Phone companies have somewhat rationalized their businesses, gotten some temporary help from the courts, and generally improved. But the switch to gas has proved timely, if not perfectly so, and benefited the portfolio significantly.

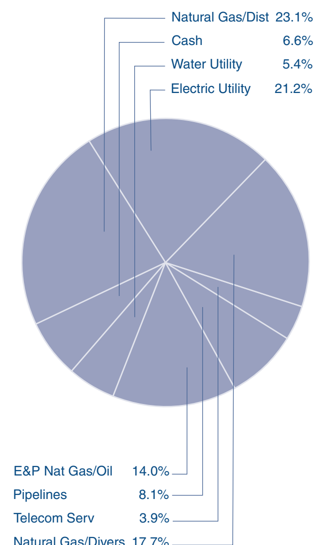
This past quarter, even though cooling degree-days were more than 20% below normal, seven of our top ten performers were gas-related companies, and each of them returned double digits. EOG Resources returned over 10%, Burlington Resources nearly 13%, Anadarko 13%, National Fuel Gas 13%, and Questar over 18%, to name several.

We're the type of manager who gets a bit queasy when stocks rise sharply, but we think the underlying fundamental situation is still developing and has far more to run, so we haven't sold these issues. Indeed, they are still priced to reflect far lower underlying gas prices, and we believe natural gas will easily top $10 this winter, a nearly fourfold increase from prices just a few years ago. So there may be a profit-taking pause in some producers, but we don't think this play is even past the first act, and we've added to laggard Pioneer Resources, which has been held back by skepticism over what we consider a fine merger with Evergreen Resources.

In our Income-Equity portfolio we've been buying some stocks offering one-time special dividends when we believe that the stock can rise back to at least the pre-dividend level in relatively short order, and this quarter we found an item that worked for our Utilities portfolio as well. Indeed, years ago we had owned Citizens Utilities with some success, until it began to change its stripes and become Citizens Communications, a rural telecom aggregator. Since rural is the least threatened segment of the telecom world, we got interested in Citizens' offer of a special dividend of $2.00 or about 14%, plus an ongoing regular dividend equalling more than a 7% yield which we consider safe. We bought in advance of the dividend, and by quarter's end the stock had recovered ¾ of its ex-dividend price, meaning that we had captured about 1% per week, in cash, for our position. We doubt the stock can maintain that "annualized" rate of return, but we're content that at times it pays to be opportunistic.

LOOKING FORWARD

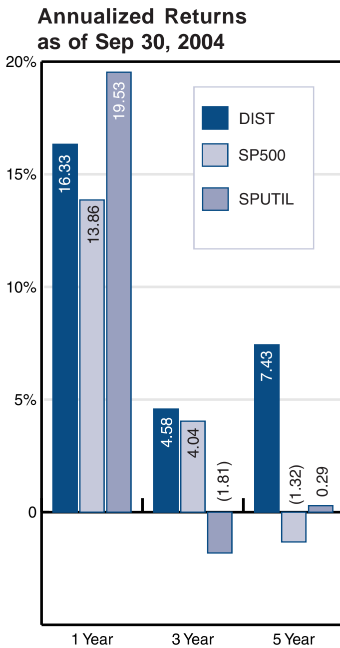
We've been in the best place to be this year, and for the trailing twelve months. We doubt there are many strategists who would have predicted this last fall, in the midst of the junky rally that was 2003. And we suppose we need to include ourselves in this group, but we can't say we're totally surprised, since our tortoises have won the race at many points in the past. Clearly the rate of return for the 3rd quarter isn't sustainable, but we've got lots of strong areas in our portfolio that continue to show promise. We don't think the broader investment world has really grasped the situation in natural gas—though it's no longer the secret it once was—and we don't have trouble envisioning a kind of panic in the markets should we have an especially cold winter combined with continuing economic growth. Economic growth may not be forthcoming, however, if high energy prices have a dampening effect on the economy. Should that be the case, our companies will likely again lead, since, as we often say, "you have to turn on the lights." As now, our area will be perceived as a haven of safety and reliability, with yields that are competitive with fixed income. Too, we hold a number of distribution companies that are excellent takeover candidates, and these don't need a strong macro background to perform well. Since we do have trouble envisioning an overall environment that is very different from today, we continue to envision positive returns in the periods upcoming, though perhaps not as mighty as those we've just seen. ❑



FUNDAMENTAL CHARACTERISTICS

Yield	3.8%
Proj Dividend Growth	4.9%
Payout Ratio	48.9%
Market Cap (MDN)	$3.3 Bil
Price/Book	2.0
P/E Ratio (MDN)	14.9
S&P Rating	BBB+
Beta*	0.61
Standard Deviation	15.8

**Relative to S&P500, 9/30/94 - 9/30/04*



Quarter Composite Net of Fees*

Distribution (Prelim)	5.0%
S&P 500	(1.9)%
S&P Utilities	6.7%

1-Year Composite Net of Fees*

Distribution (Prelim)	16.3%
S&P 500	13.9%
S&P Utilities	19.5%

5-Year Composite Net of Fees*

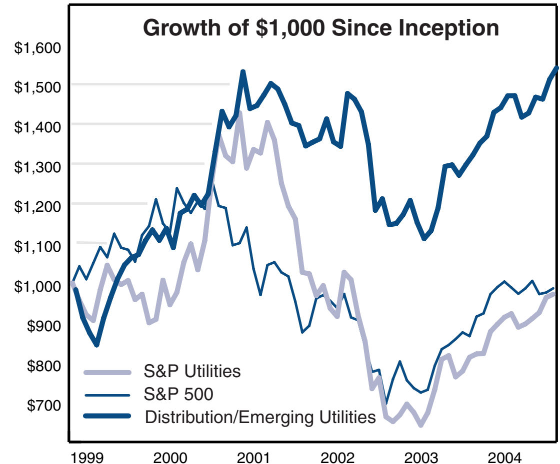
Distribution (Prelim)	7.4%
S&P 500	(1.3)%
S&P Utilities	0.3%

Included are all unrestricted portfolios that have been managed for one full quarter. As of 9/30/04: 124 accounts, representing 92% of total assets managed in the strategy with a dispersion of 0.10. Inception: 12/98.

We've frequently suggested that the appeal of this strategy is in the value which will be unlocked by a revival—a revival that we think is inevitable—of corporate transactions in the utility distribution industry, and that until the revival revives you get paid to wait. We were paid quite nicely this quarter (and this year-to-date) at a time when other equity investors mainly struggled, so we're satisfied that our theory and reality remain in harmony.

There still have not been transactions in publicly held securities lately, but there are signs that the pot is beginning to boil. Two of our companies were buyers: Atmos Energy bought the gas transmission and processing assets of Texas Utilities and Southern Union teamed up with a unit of General Electric to buy the prime pipelines of the bankrupt Enron. In both cases the stocks held their value or rose, indicating to us that our companies bulked up without losing their value as acquisition candidates: in other words, as we saw on several occasions earlier during the M&A boom of 1998-2000, the companies became arguably more attractive by increasing their scale. We're particularly intrigued by the pairing of Southern Union (SUG) and GE. SUG is something of an undiscovered gem in the gas industry, and we think that's in part a function of management being perceived as something of an unknown quantity. That GE is willing to partner with them on the equity level, rather than financing the deal as a creditor, is some kind of a message; GE's due diligence as a partner speaks well of SUG management.

The energy area has actually seen many recent transactions, but they have been



primarily in the electricity generating area—where we've not wanted to participate due to substantial overcapacity in most geographic areas—and the activity has nearly all been in the private equity arena. Interestingly, investment bankers like Goldman Sachs, Credit Suisse, Morgan Stanley, and Merrill Lynch have stepped in to fill the void left by the collapse of Enron and its imitators, and have bought a number of generating plants in support of their trading activities. We're kind of tickled by the irony inherent in this movement, since it was surely the investment bankers who tantalized Enron and many others into their fancy financing vehicles, and sold their paper to anyone who would buy it anywhere in the world. Indeed, even now the investment bankers are facing lawsuits and criminal charges for their role in the energy financings of the late 1990's and early 2000's. Perhaps if they can buy trading operations and generating assets at pennies on the dollar it will all even out for them, but we suspect something better than even will be the eventual verdict.

More importantly for the distribution stocks which are of interest to us, National Grid

sold its UK gas operations in a rousingly successful auction that brought 20-30% more than expected, giving the company about $10 billion to spend on special dividends and the pursuit of US distribution assets which it has said is next on its agenda. We have strong ideas about which companies they would be interested in buying—several don't require repeal of PUHCA for purchase—and we hold these in our portfolio. Too, any other Euroland company that's interested in US distribution assets (and there are several already in the market) will be thinking about what to do with their strong Euros, now that a gorilla has expressed its hunger for our unique bananas.

PORTFOLIO HIGHLIGHTS

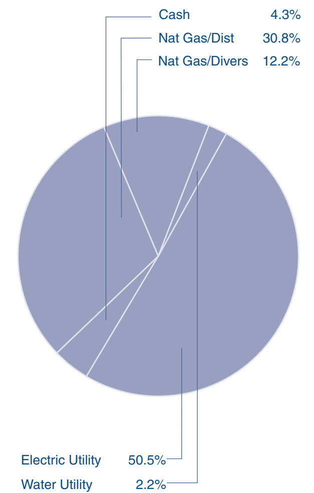
We sold NUI this quarter, as the stock was quite close to its takeover price. This wasn't a winner for us, but the position did confirm that at the right price distribution utilities are indeed takeover candidates, with or without PUHCA repeal. We added to positions in Energy East and CH Energy, two stocks we think may be in the sights of foreign acquirers in the fairly near term. We trimmed Questar, a heavy weight, as it reached new all-time highs based on its successful natural gas E&P exposure. We sold Century Tel completely. Though the company is doing fairly well, our thinking has been, increasingly, that there is a paucity of potential buyers for a non-urban telecom company. Indeed, recently Citizens Communications provided a special dividend to holders (which we bought) because it had unsuccessfully exhausted all attempts to find a buyer. Since this portfolio is focused on takeover candidates, we elected to take profits and move elsewhere.

Nearly all stocks were up this quarter, and the few that were down were down only nominally. The portfolio was led by gas-related issues such as Questar, ONEOK, Energen, Keyspan, and Sempra. But Teco and Potomac Electric both had good turnaround quarters, as did California Water and PNM Resources (Public Service of New Mexico). So there was considerable balance in the portfolio, a reflection of the overall strength in utilities generally, as well as developments in the specific names we hold.

LOOKING FORWARD

We feel a bit like Beckett's clowns, waiting for an energy bill as our Godot. As you know, an energy bill will almost certainly include a repeal of the Public Utility Holding Company Act, which will remove considerable restrictions on takeover activity in the utility area. But there are still many stocks that are likely takeover candidates whose candidacy is unrestricted by PUHCA, and there are now new signs that such action may be incipient. Speaking of candidacy, we are in one area where the election results should have clear consequences. There will be at least in part a new cast of characters, and a new morning line on passage of an energy bill.

Generally, though, conditions have been good for our kinds of stocks, and we don't expect that to change anytime soon. While returns might be due for a bit of a rest after recent strength, we would expect any correction to be mild in these assets whose constituency seems increasingly assertive. ❑



FUNDAMENTAL CHARACTERISTICS

Yield	3.6%
Proj Dividend Growth	3.6%
Payout Ratio	60.6%
Market Cap (MDN)	$2.53 Bil
Price/Book	1.6
P/E Ratio (MDN)	14.6
S&P Rating	BBB+
Beta*	0.37
Standard Deviation	13.8

**Relative to S&P 500, 9/30/99 - 9/30/04*

"Dividends become a tool for investors to determine the persistence of earnings changes, which is, said differently, all about the credibility of past reporting."

We were recently perusing a paper by Adam S. Koch and Amy X. Sun of Carnegie Mellon University in which they tested 6,395 dividend change announcements made by 1,682 publicly traded companies between 1983 and 1999 (compared to over 37,000 "no change" cases), in quest of several hypotheses regarding the meaning of dividend changes with respect to past and future earnings changes.

While most observers consider dividend changes to be an information cue about the future prospects of a company, Koch and Sun take a different tack, one which is quite timely in this age of a general culinary approach to corporate bookkeeping (most recently it has turned out that Fannie Mae was lying all long). Rather than focus on dividend increases as a message from management about the future (Healy and Palepu, 1988), they have determined that dividend changes are a kind of certification of previously reported earnings changes—just as valuable for investors, though the focus is more on the past than the future. Dividends become a tool for investors to determine the persistence of earnings changes, which is, said differently, all about the credibility of past reporting.

To quote their abstract, "We examine whether the market interprets changes in dividends as a signal about the persistence of past earnings changes. Prior to observing this signal, investors may believe that past earnings changes are not necessarily indicative of future earnings levels…Results confirm the hypothesis that changes in dividends cause investors to revise their expectations about the persistence of past earnings changes. This effect varies predictably with the magnitude of the dividend change and the sign of the past earnings change."

In other words, the authors are suggesting, and we agree, that investors are in a perpetual state of anxiety about the reliability of the information they've already received from management, and that when a dividend change confirms earlier reports investors are willing to reduce the necessary skepticism that is always a conscious or unconscious factor in their valuation equation.

To bring this down to earth, which we find necessary after parsing the authors' formulas (which often run a full two lines including much decoration with Greek letters in a simulacrum of algebra), if you're getting cash that means the company actually made the cash. Whether you as an investor look at it as a certification of the past or a message about the future isn't that important. What matters is that you've been given some proof of the "statements," and though there have been a few scam dividends in the past, handing out cash isn't usually the way crooked or self-serving managers operate. The end result is that an investor can mark up the valuation of the company that increases its dividend because in a world characterized by the everlasting tension between promise and certainty, at a minimum the certainty side of the equation has been strengthened.

In what we might call the Dividend Dark Ages covering 1990-2003, the armies of MBAs occupying the intermediary slots in the investment food chain insisted that dividends were foolish, that book entries are the same as money, and we should trust our corporate managers to wisely invest surplus earnings in ever greater growth, or, at worst, to buy back stock and kite the value of our holdings as well as their options.

As we know, this philosophy among investors has amounted to granting managers of publicly held corporations a license to kill, or at a minimum the license to manipulate share prices through devious accounting—which is perfectly understandable since the bulk of their

compensation is in shares.

Anti-dividend philosophies have been concocted by academically trained functionaries who forget that investing isn't about the numbers that are so easily melted in spreadsheets or "massaged" in investment strategy modeling software. Investing is about a human relationship between someone with capital and someone who needs that capital to make or sustain a business.

Let's say your acquaintance wants to start a hip fashion boutique. You think he (or she) understands the business and can manage it, so you invest some money. A little soft on your manager and the pro-forma profits outlined in the business plan, you take stock in the venture, as a minority holder. A location is found, a lease is signed, the shelves are stocked and the sign goes up; before you know it there's a grand opening with colored flags and a full-page ad in the local paper. Ka-ching, Ka-ching, little skirts and hoop earrings are moving out the door to the seemingly constantly filled parking lot.

By and by it seems that the business is quite profitable, and you think you should share in the profits. But your manager says whoa, he's got a line on a great location for a second store. Business has been so good that he can open it from funds internally generated, no need for additional capital, so now you're going to own a piece of two stores, not just one, for no additional investment! The prospect of growth for your investment quiets you down, and any misgivings you might have had about the cost of your manager's new home and new Porsche seem to fade as you count on your fingers how much two stores might be worth.

Of course this calculation is significantly impacted by the future promise of value, rather than any present return. Of course boutiques do have a market value, roughly speaking, and you can determine what one store and two stores that are profitable might be worth to a buyer, but until there's a buyer you have only the promise. There is only theoretical value without a transaction.

You think maybe you'd like to have a nice new car, too, so you raise the issue of distributing profits once again. But once again your manager has a plan for expansion—this time for a mega-boutique in the new mall that's going up. Rents are premium there, but the retail traffic should be incredible. And so you wait, once again, while the investment you made has babies and more babies, and its babies have babies.

One can see where this is going, and we needn't reveal the ending by announcing the ultimate fate of the business. The simple fact is that an investor is always caught in the dialectic between the certainty of a cash return now and the promise of a greater return later. Why is it so difficult for investors to insist on some level of balance between the two?

Why do investors persist in accepting the projections of managers about the future without taking in some real return from the accomplishments of the past?

This is the human face of dividends, the true actuality of dividends: you invest money in a business and the business pays you back some of its profits in real time, while retaining enough for sustainable and reliable future growth. You receive confirmation of present success, you receive a return on your investment which is minimally a hedge against future failure of the business, you receive a share of profit which goes to the investor and not the manager (this is only fair), and you retain a position in the business which can bring you more of the same indefinitely.

What strange twist of the psyche would have it any other way? ❑

"Why do investors persist in accepting the projections of managers about the future without taking in some real return from the accomplishments of the past?"

THINK DIVIDENDS

"Do you know the only thing that gives me pleasure? It's to see my dividends coming in."
-John D. Rockefeller

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
Income-Equity Strategy	Dividend growth companies, broad market	5.7%	4.0%	0.5	14.0	15.8%
Better Than Bonds/Utilities	Utilities sector: natural gas, electric, telecom, and water	3.8%	4.9%	0.6	14.9	20.2%
Distribution/Emerging Utilities	Local distribution utilities, takeover candidates only	3.6%	3.6%	0.4	14.6	16.3%

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