

## MARKET OVERVIEW

**T**he environment remains static, swirling and eddying with cross-currents, notable for its enigmatic and novel features, frustrating, nervous, and lacking in either positive or negative verve. The S&P 500 is essentially unchanged since early 1999 (albeit with a burst bubble and partial recovery in the interim) and volatility has dwindled to levels reminiscent of the 1930's—which may not be a coincidence. The “trading range” notion seems less of an interim concept with each passing year.

The economy is reportedly strong, though only the rich believe that it is. Short-term rate increases by the Fed have failed to budge historically low long-term bond rates, prompting questions about how large a role Fed funds rates play after all. Pundits explain the strength of bonds as a result of the world's central banks' insatiable appetite for the securities of a debtor nation with a feeble current accounts balance. This may be the correct explanation; if so, we're disappointed that global central bankers are as likely as anyone else to sacrifice prudence for short-term rewards, since a moment's glance at the larger U.S. fiscal situation reveals—as does a moment's glance at General Motors' situation—the wall at the end of the tunnel. For as long as we can remember it was said that “as GM goes so goes the nation.” We remain hopeful that GM may soon be contemplating a restructuring and can evolve into something more than an HMO with vast pension liabilities and an endless procession of poorly designed automobiles. Will the nation go as GM has gone?

No doubt we underestimate the tough resilience of the domestic economy and its ability to grow fast enough to handle its mounting debt burdens (the economy has, after all, poured forth sufficient tax receipts recently to diminish the current estimated budget deficit). But the looming shadow of a very different world, in terms of interest rates and the value of the dollar, can't be far from the minds of investors generally, and this shadow must explain why stocks have been so difficult an arena despite many notable earnings success stories in a variety of sectors. The larger macro issues may take a long time to unfold, and there will surely be plenty of opportunities in the interim, but this shadow creates an upper ceiling even as decent valuations and the evident resilience of the economy create a floor. Thus, in the absence of new developments, it's hard to escape the inexorable conclusion of a continuing range-bound landscape.

Looking at the details, here is a compressed version of our “ten points.”

- 1) The consensus of “watchers” believe *the Fed* has one or two rate increases left. But the Fed has become quite reactive, and since no one really knows

### 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.

TABLE OF CONTENTS	PAGE
MARKET OVERVIEW	1
BETTER THAN BONDS/UTILITIES	3
INCOME-EQUITY STRATEGY	6
DISTRIBUTION/MERGING UTILITIES	8
ABSOLUTE VALUE	10

“...individual investors are perplexed (particularly by the meaning of higher energy prices), and not likely to provide fuel for the market’s fires.”

how the economy will unfold, there’s little point in anticipating the end of Fed moves. To be sure, falling rates are a better environment for stocks than rising, though at this moment an end to Fed tightening could well imply a sputtering of the economy. We will hear a lot this quarter about the meaning of a yield-curve inversion. We’re covering our ears, however, since we know that there have not been enough such cases to warrant meaningful generalizations.

- 2) *The global political situation* remains a wild card, as does the potential for terrorism almost anywhere. This, along with the US macro financial picture, will dampen periods of equity market enthusiasm.
- 3) *Traditional sentiment measures* are not favorable for a rally—too many oratory bulls, not enough bears. The advance-decline has struggled and rolled over, which is a negative.
- 4) *Our proprietary sentiment indicator*, measuring open interest in index puts and calls, continues to suggest that among players (as opposed to pundits) there is caution, and under current conditions declines should be contained.
- 5) *Valuations* also suggest that declines may be modest, as most measures have returned to normal ranges. That’s not to say stocks are cheap or bargains, and valuation formulas would be stressed here by higher interest rates and a deceleration of profits growth.
- 6) In the beginning of 2005 we thought *dollar strength* was more likely than dollar weakness. Now we tilt in somewhat the opposite direction, with a view that other countries’ debt and equity markets are becoming relatively more attractive at the margin.
- 7) *Mutual (and other) fund cash flows* are to some extent built into the system through

retirement investing. But flows have slowed, individual investors are perplexed (particularly by the meaning of higher energy prices), and not likely to provide fuel for the market’s fires. However, corporations are loaded with more cash than ever; buybacks and takeovers are likely to induce a “cap-shrink” which replaces fund flows as a bullish force.

- 8) *Earnings* have been the upside surprise that have buoyed the market in the face of uncertainties and stress from energy costs. We don’t have a prognosis in this area right now, except to think that the rate of acceleration is likely to slow (from a historic growth spurt).
- 9) The *hidden tax* factor continues to play an important—if hidden—role. With calls to increase the minimum wage failing at the federal level, more and more states are increasing this cost. And yes, our real estate taxes are rising again, along with our driving, heating, and cooling costs.
- 10) *Insider buying* activity has ground to a near halt. Insiders are not optimistic.

They say the market climbs a wall of worry. If so, from our point of view, some of the pieces for a rally are in place. But in the real world (the world of others, to be precise!) there really isn’t enough worry for us to imagine that any rousing market rise is a near-term prospect. From wire house strategists to bloggers, only positive returns are envisioned. Still, with all the verbal noise bound to come this quarter about rate curve inversions and dwindling energy supplies, we may just get a pullback deep enough to warrant more bullishness—since valuations are not threatening. Perhaps that’s just wishful thinking, as our Ask The Eight-Ball toy keeps popping up with “more of same.” □

#### SELECTED INDICES

	4 <sup>th</sup> Qtr’05	12 Mo
<b>S&amp;P 500</b>	2.08	4.91
<b>Equity Inc</b>	0.61	4.32
<b>Util Fund</b>	(4.44)	13.55
<b>R3UTIL</b>	(3.84)	8.83
<b>LB Long</b>	1.07	6.50
<b>LBGC</b>	0.60	2.37
<b>S&amp;P 400</b>	3.34	12.45
<b>Wilshire 5K</b>	2.32	6.32

S&P 500 = Standard & Poor’s Index  
 Equity Inc = Avg Equity Income Fund (Lipper)  
 Util Fund = Avg Utility Fund (Morning Star)  
 LB Long = Lehman Long Government  
 LBGC = Lehman Bros. Gov/Credit Bonds  
 R3UTIL = Russell 3000 Utilities  
 S&P 400 = S&P Mid Cap Index  
 Wilshire 5K = Wilshire 5000 Market Index

**A** correction—one might say an overdue correction—developed in October and November, after a third quarter rally that was one of our best. This pullback clipped our returns for the year but our 2005 was, nevertheless, among the leaders of any equity strategy, and substantially in excess of benchmarks. The retrenchment was a little bit inevitable, since nothing goes up in a straight line. But as the dust has settled (including the beginnings of a rally in December and early into January) we feel comfortable with our strategy and its execution, and we believe our portfolio is well-positioned going forward.

## PORTFOLIO HIGHLIGHTS

As expected, the large-cap utilities (which we don't own) were subjected to vigorous profit-taking, and they set a negative tone for the sector generally. It was our view that the non-traditional segment of our portfolio—gas stocks, foreign phones, enablers, and unique situations—would insulate us from the expected decline in headline utilities, and to some extent it did. But gas stocks and gas-producing utilities corrected simultaneously with general utilities (oddly, these two groups, which should be only loosely correlated, have been running neck-and-neck for two years). Combined with surprising declines in some distributors and some previous portfolio leaders, our portfolio was only able to perform along with the indices.

What was heartening during the fourth quarter was that our newer and more creative ideas led the portfolio, posting positive returns.

Leading the pack were PT Telekomunikasi Indonesia (the primary telecom company in Indonesia) and Telefonos de Mexico, both up more than 10%. This was especially satisfying in light of the domestic telecommunications index, which was slightly down for the quarter. Both companies delivered double-digit sales and earnings gains, which is a good deal better than any domestic phone company. It's been some time since we used an equipment supplier in this portfolio, but early in the quarter we found Nokia was just too cheap considering its blue-chip presence in the cellular industry, an industry with a clear wind to its back in terms of phone sales globally. We took a relatively modest position to account for its different volatility profile, and so far it has worked out well.

Though we've always been partisans of distribution and vertical integration in the utility industry, there are now signs (in the form of healthier spark spreads, or margins) that the excesses of generating plant construction which characterized the opening of the decade are being worked off, and that both the operating profile and the valuation of generating facilities are improving. If we had any doubt about that, FPL's purchase offer for Constellation Energy—one of the most successful merchant operators in addition to its strong local utility—provided certain resolution. We added NRG to our third quarter purchase of Dynegy as a way of participating with a pure play on generation. NRG is a survivor of the earlier turmoil in the industry (it was created by XEL Energy and later spun off) and has grown nicely in the past three years. Further, the company is about to double in size as a result of its purchase of the generating assets of Texas Genco. Often a deal of this size is cause for investment caution, but

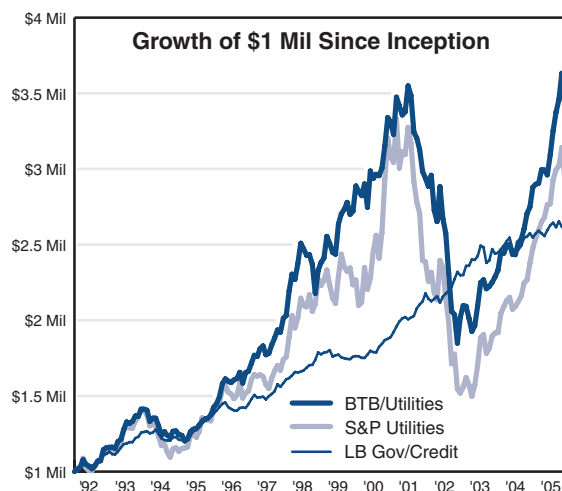
*"But as the dust has settled (including the beginnings of a rally in December and early into January) we feel comfortable with our strategy and its execution, and we believe our portfolio is well-positioned going forward."*

*"We've come far in the past three years—far further than the S&P 500, in fact—and the potential may not be as great as it was, but we think 2006 can be a solid year both in absolute terms and compared to the broader market."*

our thought is that both managements are well proven (as are the assets involved), and by the end of 2006, NRG will have only roughly 50% debt, which is reasonable for a company in this business. From an unscientific vantage point, we've always done well with investments in companies making a quantum leap in their own industries with reasonable financing. So far so good, as the stock is up about 10% since purchase in November.

But we're not necessarily biased in favor of size. Northeast Utilities is shrinking to some extent, exiting the remainder of its wholesale operations. But the company already has approved several billion dollars for capital spending projects which will unfold over the coming years, virtually guaranteeing high single-digit to low double-digit growth. This outstanding organic growth is combined in our minds with a view that this stock is a likely takeover candidate (Con Edison offered for it within the past five years), and the stock deserves a place in this portfolio.

What's a semiconductor stock doing in a utility portfolio? We've noted that we want to include more equipment suppliers and enablers at this point, and Cypress Semiconductor fills the bill because it is the 87% owner of Sunpower, a manufacturer of the most efficient solar panels on the market today which is experiencing enormous growth. Indeed, Sunpower came public during the quarter and promptly gained about 30% in a month. Our gain in CY is nowhere near that magnitude, but we're counting on continuing growth in Sunpower to boost CY's growth, and we wouldn't be surprised to receive spun-off shares at some point in the future. We don't



generally buy IPOs in this portfolio, but we might add more Sunpower directly at the right price. In any event, this relatively small position is one way to position the portfolio more pro-actively in alternative energy while still retaining our investment perspective and discipline.

We completed our selling of Aqua America this quarter, near the all-time high. It may be a stretch to say that water can make you nauseous, but we experienced vertigo (at least!) from the stock selling at about 35 times earnings. Yes, water's a good business, but... American Water Works, a much better company, was sold to RWE in 2001 for 28 times earnings, and RWE is now shedding it because the returns on investment aren't strong enough.

We had some downside surprises in the portfolio which we expect to recover shortly. MLPs Enterprise and Kinder Morgan were knocked back for reasons unknown. They weren't overbought and they haven't experienced fundamental problems. Indeed, neither was affected by the Gulf of Mexico hurricanes and both continue to post estimate-beating returns. ONEOK took a jarring drop

#### Quarter Composite Net of Fees\*

BTB/Util (Preliminary)	(5.8)%
Russell 3000 Utilities	(3.8)%
S&P Utilities	(5.5)%
LBGC	0.6%

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

BTB/Util (Preliminary)	18.1%
Russell 3000 Utilities	8.8%
S&P Utilities	16.8%
LBGC	2.3%

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

BTB/Util (Preliminary)	8.0%
Russell 3000 Utilities	2.9%
S&P Utilities	6.7%
LBGC	6.2%

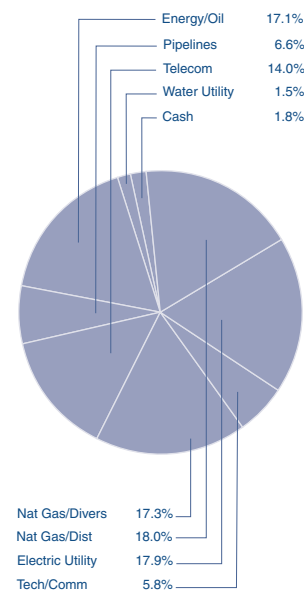
*Included are all unrestricted portfolios that have been managed for at least one full quarter. As of 12/31/05: 155 accounts representing 95% of assets in the strategy, with a dispersion of 0.35. Inception: 9/91.*

of 20% on a modest reduction in company guidance. But the company is in the midst of re-configuring assets and the numbers are temporarily far less meaningful than the price action would imply. This is an excellent company with a comparatively recent MLP general partnership which can greatly enhance its business, and is a classic buy on oversold pricing. Brasil Telecom hurt this quarter on profit-taking though it has helped us this year. The same is true for Sierra Pacific; this is one of our highest-confidence-level stocks and one of our best performers for the year, but every big run attracts profit-takers at some point. Distributors NiSource, Keyspan, and Energy East all offered relentless downward pricing through the quarter, but they are all prime transaction candidates, and if we could buy the whole company in these cases, we probably would.

## LOOKING FORWARD

We think the correction in utilities and gas is done or all but done, and that the portfolio, as mentioned earlier, is very well positioned. It's not easy to hold our gas stocks after such strong gains; but we see no change in the case for high natural gas prices, our companies are minting money, and their stock prices discount future natural gas quotes that are unrealistically low. Deals are beginning to emerge, and shareholders are likely to get distributions from the mountains of cash (or takeover offers). Our distribution companies are back at valuations similar to those before the last big consolidation wave in 1998-2001. Our MLPs are mispriced. And the large-cap utilities, having absorbed

profit-taking in decent form, probably won't set a downbeat tone in the months ahead. We've come far in the past three years—far further than the S&P 500, in fact—and the potential may not be as great as it was, but we think 2006 can be a solid year both in absolute terms and compared to the broader market. □



### FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	3.2%
<b>Proj Dividend Growth</b>	7.0%
<b>Payout Ratio</b>	54%
<b>Market Cap</b>	\$16.4 Bil
<b>Price/Book</b>	2.6
<b>P/E Ratio</b>	15.8
<b>S&amp;P Rating</b>	BBB+
<b>Beta*</b>	0.6
<b>R-Squared*</b>	0.5
<b>Standard Deviation</b>	15.1

\*Relative to S&P500, 12/31/00-12/31/05

*Disclosure: Gross of fees performance is based on actual results calculated by using Checkfree Security APL's portfolio accounting software, which uses the BAI method of calculating performance. Contributions are time-weighted to the day and performance is linked to monthly calculate cumulative performance consistent with FAF (Financial Analysts Federation) guidelines. A complete list of all composites is available. Net of fees performance is calculated by deducting an annual fee of 100 basis points from gross of fees performance. 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.*

*“Current yield on the portfolio is 5.4%...Bear in mind that the stated yield doesn’t include special dividend stocks we may decide to use. In fact, such stocks helped the portfolio provide a yield from income of 6.8% in 2005.”*

The fourth quarter wasn’t a happy period for higher yielding stocks, as profit-taking from earlier strength, tax-loss selling in laggards, and a brief shift in buying activity toward both industrial and growth names conspired to place our strategy in the somewhat unaccustomed position of trailing the field. Based on initial returns for the first quarter of 2006 this seems to be a transient adjustment in the markets, and there’s certainly been no deterioration in the fine underlying fundamentals of our stocks. Returns declined in October along with everything else in the market, as interest rates burped upwards, but though rates calmed in November our stocks didn’t respond nearly to the level of that month’s large-cap and growth rally. December outperformed the market, though, and, as noted, things seem to be back on track as of this writing.

**Quarter Composite Net of Fees\***

Income-Equity (Prelim)	(2.6)%
50/50 SP500 & Long Treas	1.6%
Russell 1000	2.1%

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

Income-Equity (Prelim)	3.3%
50/50 SP500 & Long Treas	4.5%
Russell 1000	1.1%

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

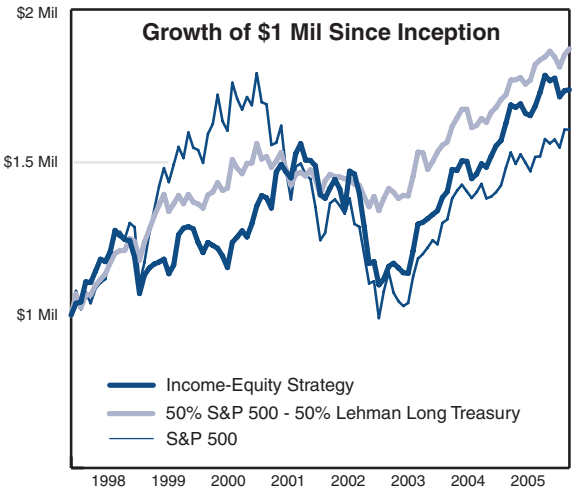
Income-Equity (Prelim)	5.7%
50/50 SP500 & Long Treas	4.7%
Russell 1000	2.3%

*Included are all unrestricted portfolios that have been managed for one full quarter. As of 12/31/05: 481 accounts in composite, representing 57% of total assets in the strategy with a dispersion of 0.40. Inception: 5/97. We offer a customized version of Income-Equity that excludes Master Limited Partnerships. These accounts are not included in the composite and represent 31% of the total assets in the strategy.*

**PORTFOLIO HIGHLIGHTS**

Pipeline-related companies have frequently been leaders in our portfolio over the past five years, and have sometimes been subject to inexplicable periods of market-independent weakness which were typically soon corrected. The fourth quarter was definitely one such period of weakness—and it accounted for much of our reduced return—as stalwart companies like Kinder Morgan, ONEOK, NiSource, and Enbridge, all saw double-digit declines, with distribution utilities Energy East and Southwest Gas contributing to the softness. Elsewhere, the portfolio was dragged down primarily by stocks that did well over the year such as BP, Tidewater, Nam Tai, and RR Donnelly, but which experienced profit-taking.

There were definitely bright spots (in fact only October was dark). On the plus side, the portfolio had several stocks that swam against the current. ING Groep, a Dutch bank, insurance company, and asset manager,



provided solid double-digit gains on strong earnings and rising prospects, as most observers believe a turnaround has been accomplished here. Our main domestic turnaround idea, UnumProvident, the largest group disability insurance company in the U.S., rose nearly double digits as well. Though oil prices and stocks corrected, Enerplus - a Canadian oil royalty trust - still managed to turn in a gain.

While we are generally cautious on banks, we like US Bancorp because of its growing fee-based income, strong loan growth, and shareholder-oriented management, which helped push the stock up 6.5% during the quarter. However, our concern over narrowing bank interest margins and unusually low credit costs caused us to sell KeyCorp and Regions Financial Corp—even though we still like them as takeover ideas. We’re quite cautious on the banking sector in general now, and it will take a standout like US Bancorp to move us in that direction until conditions improve. We also sold Chubb near its recent high.

Tanker rates rose as we expected this fall, but appeared to peak at lower levels than previously, so we sold volatile Frontline Ltd. before charter rates declined further. We were able to extract several large dividends from this position, but the prospect of mounting tanker supply in 2006 combined with rates that

were merely strong but not very strong implied more risk than we wanted to undertake. We continue to be interested in both wet and dry shipping companies, but will look for more stable freight rates before investing, and focus more on LNG than oil. Finally, we sold shopping center REIT Urstadt Biddle Properties based on valuation and liquidity concerns after a soft quarterly report .

We added several rather exciting new names to the portfolio. CapitalSource Inc. is an intriguing business finance company that is converting to a REIT. We already collected a \$2.50 special dividend and CSE will be a regular payer at around 10% going forward. We first noticed this company after seeing reports that insiders had purchased several hundred million dollars of common stock after a secondary offering. Most unusual. We see this as a potentially very rewarding high-yield position.

A smaller addition also with extraordinary insider buying was Global Signal Inc, a specialty REIT which owns cellular telephone towers. The company should see strong earnings growth as more wireless services need more antennas to be mounted on their existing towers. Precision Drilling Trust is a Canadian oil driller with a 30% market share in Canada that has just converted into a tax-advantaged investment trust. For conservative exposure to natural gas we added Equitable Resources, which holds considerable gas production and acreage in the Appalachians, in addition to operating a regulated gas distribution utility. Not only is this gas close to their customers (reducing transportation costs) but Appalachian gas wells, while not big producers like wells in the Gulf of Mexico, are long lived and relatively easy and cheap to drill. We seem to have added auto equipment manufacturer Autoliv at the right time, as the stock has come alive. ALV makes air bags and seat belts, and is a beneficiary of consumer's demands for increased safety

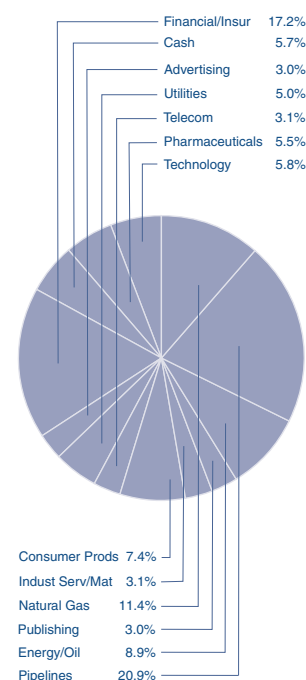
systems in new cars. Not only do they stand to get an increasing percentage of each automobile using their products, they're relatively underexposed to the large North American auto producers and their volatile production schedules.

During the month we received special dividends from several holdings. CapitalSource needed to distribute earnings to convert to a REIT (about 12% on the share price), Fidelity National Financial distributed shares in a subsidiary worth \$4.25 or more than 10% on FNF's share price, Clear Channel distributed shares in its concert subsidiary worth about 5% on our position, and Anixter International, which we bought and sold for the same price, paid a \$4.00 special dividend in the interim, giving us a gain of 10% in just a couple of months.

## LOOKING FORWARD

Right now we think our portfolio is populated with stocks with strong and growing income, and with capital gains potential as high as we can recall. We might add a position or two in the upcoming quarter to establish some sector breadth or depth, but we doubt there are many changes in the offing. If pressed, we'd suggest that the weak shall become the strong, and some of the laggards this quarter (we added weight in EPD and NBP) will turn out to be next quarter's winners.

Current yield on the portfolio is 5.4%, with a projected dividend growth for 2006 of 4.75%. Bear in mind that the stated yield doesn't include special dividend stocks we may decide to use. In fact, such stocks helped the portfolio provide a yield from income of 6.8% in 2005. □



## FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	5.4%
<b>Proj Dividend Growth</b>	4.8%
<b>Payout Ratio</b>	46%
<b>Market Cap</b>	\$30.1 Bil
<b>Price/Book</b>	2.8
<b>P/E Ratio**</b>	14.8
<b>S&amp;P Rating</b>	BBB+
<b>Beta*</b>	0.6
<b>R-Squared*</b>	0.5
<b>Standard Deviation</b>	12.1

\*Relative to S&P 500, 12/31/00 - 12/31/05

\*\*REITs use P/FFO ratio

*"We believe the recently reduced valuations, ongoing organic growth prospects, favorable conditions for more merger and acquisition deals, and chances for an end to Fed tightening all augur well for the visible future."*

#### Quarter Composite Net of Fees\*

Distribution (Prelim)	(7.6)%
Russell 3000 Utilities	(3.8)%
S&P 500	2.1%
S&P Utilities	(5.5)%

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

Distribution (Prelim)	3.7%
Russell 3000 Utilities	(2.9)%
S&P 500	0.5%
S&P Utilities	(2.3)%

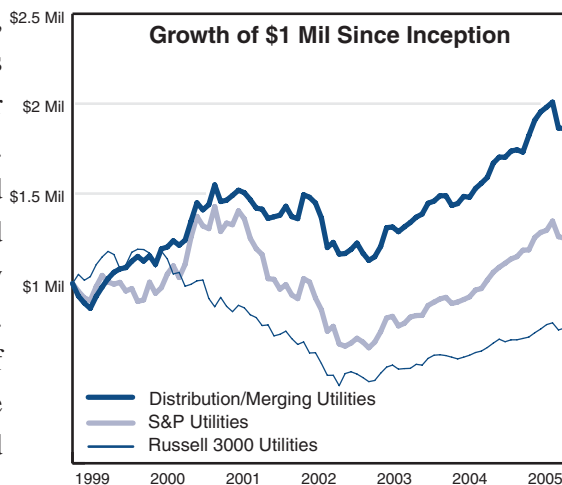
#### 7-Year Composite Net of Fees\*

Distribution (Prelim)	9.2%
Russell 3000 Utilities	(4.0)%
S&P 500	1.8%
S&P Utilities	3.5%

*Included are all unrestricted portfolios that have been managed for one full quarter. As of 12/31/05: 212 accounts, representing 95% of total assets managed in the strategy with a dispersion of 0.31. Inception: 1/99.*

Corrections are never comfortable, though the fine performance of both utilities and gas stocks over the course of the year made this quarter's down note nearly inevitable. Still, Distribution/Merging Utilities retained double-digit gross performance for the year and one of the more outstanding records of any equity strategy for the past three and five years. As we've noted many times, in the absence of deals the large-cap utility indices can set a tone for this portfolio, and investors finally decided to take profits in the index-type stocks, often apparently shifting funds into some more cyclical ideas. In our view this may be just the wrong time of the cycle to do this, but we'll see in the fullness of time where we really are. Markets are excited by the prospect of the Fed finishing its tightening, but won't that really show that the economy isn't strong enough to tolerate any more tightening? Perhaps it will merely show that inflation is under control—which would be a fine state of affairs if only everything didn't cost so much more than it did last year!

Without deals these companies aren't casting trails of light in their wake, but the prospects are very attractive for solid long-term results while we patiently wait for continued consolidation. Indeed, lots of items on our list have retreated to what we perceive as tempting valuations, if we put ourselves in the shoes of potential acquirers (which is basically how we manage this portfolio). Though our anticipated "symphony" of deals in the aftermath of PUHCA repeal hasn't yet materialized, FPL's offer for Constellation Energy wouldn't have been possible without a PUHCA repeal, and it also highlights the growing attraction of generation and integrated



utilities (as in Excelon's offer for Public Service of New Jersey) in the consolidation mix. In recent months the FERC has clarified its role as arbiter of mergers; financing costs are low but who knows how long they'll stay low—we're still expecting plenty of utility M&A, and so are the accounting firms who specialize in advising acquirers and targets, or so they say.

## PORTFOLIO HIGHLIGHTS

With the exception of Dynegy, downward pressure was evident across the portfolio. Many of the integrated gas and gas distribution names like Oneok, Nisource, Questar and Energen were among the weakest, as they were touched by both utility and gas correction pricing trends. But these have been leaders, and they will be again, sooner, we think, than later. The same is true for some of our strong turnaround names like CMS Energy, Sierra Pacific, and Centerpoint Energy. These are all fine stories, merely suffering from a temporary tantrum by the figure Warren Buffet calls "Mr. Market" (that strange irrational "man" who sometimes won't buy anything at any price, and other times will pay through the nose for whatever.)

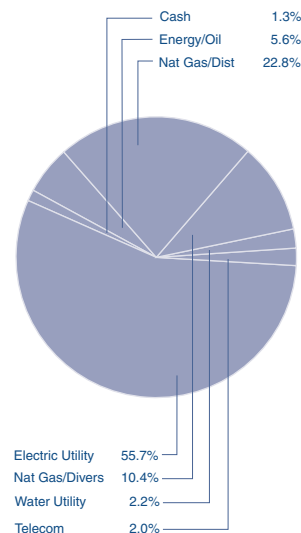
During the quarter we took advantage of the weakness in the utility group to add or increase exposure to improving situations. We added First Energy, a large integrated utility based out of Ohio. They've had a number of operational and management credibility issues over the last several years, including central responsibility for the famous blackout of August 14, 2003. Having gone through some tough times, they've improved, and there's still more room for improvement—which is exactly the stage acquirers like to buy into. The prospects for lower-cost generation in this country looks very bright in the coming years as old contracts and regulated price levels roll off; companies like First Energy can be prime beneficiaries, and it's well positioned with a coal and nuclear fleet to profit from market based prices in a couple of years. This is a good (and strategically located) target along the lines of FPL/CEG and EXC/PEG mentioned above.

We also increased our position in Northeast Utilities as valuations looked very compelling especially given the prospects for significant organic growth. They plan to spend several billion dollars over the next five years on projects that have attractive high single to low double digit returns on equity. The organic earnings growth, along with the belief that consolidation in the smaller transmission and distribution companies will heat up again, presented an opportunistic time to add to our position. UK based National Grid recently reiterated comments they made last year that they plan to make additional (a couple billion a year) investments in the US over the next few years. We believe this bodes well for the portfolio in general and especially for our

holdings like Northeast Utilities, Energy East, CH Energy and Pepco Holdings.

From abroad, we added Scottish Power, which earlier this year announced the sale of its US operation, Pacificorp, to Buffet's Mid America and was recently in discussions with German based utility E.ON to be bought. The deal with E.ON did not materialize, but the market conditions appear favorable for more consolidation across the sea too. During the quarter we trimmed exposure in names like Progress Energy, Nisource, Nicor and Energen to make room for our additions as we continue to "best position" the portfolio, though we continue to think they are good M&A candidates.

Okay, Okay, the Public Utility Holding Company Act was repealed and there's only been one new deal (FPL/CEG)...kind of anticlimactic. But the deals already announced were helped in the approval process, as were the phone deals, and with each new deal there's an additional scarcity premium attached to the companies that are left. PUHCA repeal or not, any merger must still make economic sense and given the regulatory nature of utilities, there's still the issue of the political process to navigate through the local and state jurisdictions. Now that we have seen a pause in the upward stock price moves, the economics of deals have improved. We suppose we want it both ways; rising stock prices when there are no deals, more potential premium to be gained from deals when prices are low. The net of this? Always two chances to win with these stocks, and you get paid a decent yield in the meantime.



#### FUNDAMENTAL CHARACTERISTICS

<b>Yield</b>	3.3%
<b>Proj Dividend Growth</b>	3.9%
<b>Payout Ratio</b>	49%
<b>Market Cap</b>	\$4.1 Bil
<b>Price/Book</b>	1.9
<b>P/E Ratio</b>	16.2
<b>S&amp;P Rating</b>	BBB+
<b>R-Squared*</b>	0.2
<b>Beta*</b>	0.4
<b>Standard Deviation</b>	13.4

\*Relative to S&P 500,  
12/31/00 - 12/31/05

continued on page 11...

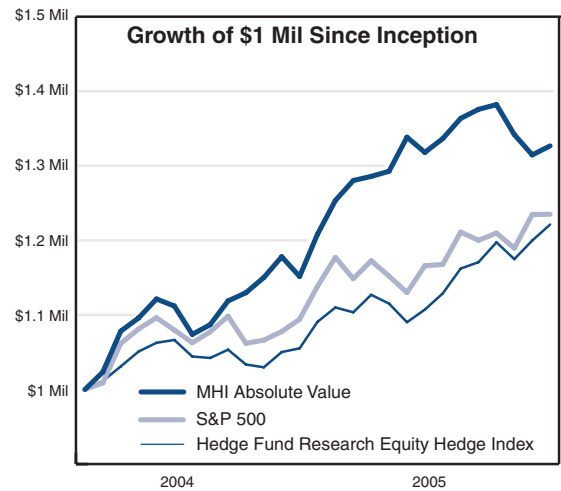
*“Since we surely don’t want to be unhedged in the event of a serious downturn we hedge every cloud. So far, no real rain.”*

Though it was no disaster, we experienced our first down quarter in eight since inception, with a net return of (4.0)%. It’s small consolation, since our goal is positive absolute returns, that the quarter was further confirmation of our lack of correlation to the equity markets, though we use equities as our primary investment vehicle. Our longer-term returns remain strong and positive and our standard deviation of 7.8 gives us a very robust Sharpe ratio of 1.68. For the year we returned 5.8% net of fees, and since inception (November 2003) we have returned 36.5% net of fees.

**PORTFOLIO HIGHLIGHTS**

Two elements hindered our progress during the quarter. First, the underlying portfolio of high yielding equities didn’t participate in the broad market’s November rally but did participate in the October decline, leaving us with negative performance on the base portfolio during a period when stocks more generally defined provided positive returns. This is kind of a rarity, but clearly, it can happen. The recovery of these stocks didn’t begin until December, and it was modest even then, though the New Year has started out vigorously. We will say that the quarter caused us to consider whether to modify the fairly passive role of the base portfolio and adapt it more to market conditions, and that study is ongoing. Of course the other side of the argument is how well it has served us in previous down market periods.

We also lost money on our hedges, and would have shown flat or slightly positive returns without them. This has pretty much been the case all year (the portfolio was hedged 50% or



more using the S&P 500 and Russell 2000 as instruments), as the low volatility market characterized by tentative and modest index movement in both directions has caused a frustrating and costly whipsaw effect on our hedging technique. We consider this just a cost of doing business, however. Since we surely don’t want to be unhedged in the event of a serious downturn we hedge every cloud. So far, no real rain.

We did well again with our additional longs and with our short positions, though in an uncertain market we didn’t make bold use of these. We took gains in short-term trades in Medtronic, Merge, Harris, AGL Resources, Duke Energy, Pharmaceutical Holders, and entered the year with unrealized gains in Celanese and Chicago Bridge. Losses on long trades were minimal in stocks such as Stone Energy, Enterprise Products, and UPS. On the short side we covered our position in Sears Holding at a nice profit, lost a bit shorting Hewlett Packard, and carry a good profit in Apollo short going into January.

<b>Quarter Net of Fees</b>	
Absolute Value	(4.0)%
S&P 500	2.1%
HFRI Equity Hedge	2.0%
<b>1-Year Net of Fees</b>	
Absolute Value	6.1%
S&P 500	4.9%
HFRI Equity Hedge	10.0%
<b>2-Year Annualized Net of Fees</b>	
Absolute Value	11.8%
S&P 500	7.8%
HFRI Equity Hedge	8.8%

## LOOKING FORWARD

Going forward we intend to broaden the sector representation of the base portfolio, and find more individual shorts, but otherwise we see the environment as a grind-it-out period that may last longer than many expect. In any event, we've positioned ourselves for that vision until proven otherwise.

We've noted that many in our constituency, including retirement accounts, non-taxable institutions, clients with less than \$1 million to invest, and consultants connected with brokerage firms, aren't able to use this strategy from a mechanical or tax standpoint. Since August we've been running a seed account in an additional hedge strategy that doesn't involve margin and will be easy to use by the above-mentioned groups. We'll have more to say about this soon. □

Gross performance is based on a representative account commencing 11/1/03. Gross of fees performance is based on actual results calculated by using Checkfree Security APL's portfolio accounting software, which uses the BAI method of calculating performance. Contributions are time-weighted to the day and performance is linked to monthly calculate cumulative performance consistent with FAF (Financial Analysts Federation) guidelines. Net of fees performance is based on a non-fee paying account. It is proforma and calculated by deducting an annual fee of 150 basis points from gross of fees performance accrued monthly. A 20% annual performance fee is accrued quarterly to the period in which it was earned. Returns are total returns, dividends are assumed to be reinvested. There is no guarantee that this portfolio will continue to provide return and risk characteristics similar to those in the past. There are additional risk factors not found in strategies that hold portfolios solely of stocks owned for cash payment. Efforts at hedging the portfolio against market declines may incur a cost. Stocks bought on margin may not provide absolute return. Stocks sold short may rise, producing losses. The strategy may show a loss over any given time period, and there is no guarantee that such a loss will be recovered. Extreme market conditions may produce losses greater than contemplated by the manager or an investor. The use of leverage may generate losses that are greater than would otherwise be the case, or losses that may not have occurred without the use of leverage. Past performance is no guarantee of future results.

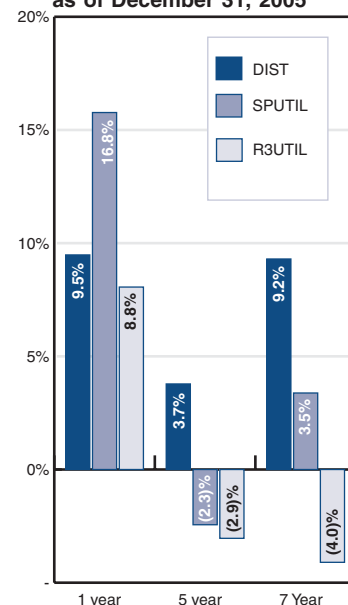
Distribution/Merging Utilities continued from page 9

## LOOKING FORWARD

It's also important to remember that the appetite for monopolistic, persistent and sustainable business models in an otherwise uncertain world, is not going away anytime soon. At current capitalization rates REITs, which do not have monopoly franchises, are selling at the equivalent of 18-20 times earnings. While industrial or other service sectors may appear to have the potential for more rapid growth, it is often a chimera, and they're not protected by government granted monopoly status. In addition to PUCHA repeal, The Energy Bill has also added incentives to deploy capital. The need to upgrade and update our country's infrastructure is real and many utilities are positioned to benefit from these factors for many years to come.

Now that some excess has been rung out, we see no reason why the strategy can't resume delivering the kind of solid results along with very low volatility that's been its hallmark since inception over seven years ago. We believe the recently reduced valuations, ongoing organic growth prospects, favorable conditions for more merger and acquisition deals, and chances for an end to Fed tightening all augur well for the visible future. As always, we continue to shape the portfolio and position it for ongoing success. □

Distribution/Merging Utilities  
Annualized Returns  
as of December 31, 2005



Below is an excerpt from the revised edition of Lowell Miller's classic guide to long-term investing, *The Single Best Investment - Creating Wealth with Dividend Growth*, available in stores March 2006. It's interesting to note that this paragraph was first published in 1999 - in the midst of NASDAQ mania.

“Over the long term, conservative and careful investors are the ones still standing when the dust settles. Sometimes, when the latest new technology company is doubling and tripling overnight it may seem that you need to be an aggressive gambler, but these newsworthy moonshots are actually few and far between. More often than not, speculation will deplete your capital. Investors need to be willing to ‘take *human* bites,’ to seek gains that are commensurate with a moderate risk profile. Only a moderate risk profile will permit investors to attain the cool head and future-vision which is necessary to reach the *confidence level* that only *common sense* can bring. Too much or too little risk, and the brain just stops working.”

- Lowell Miller, *The Single Best Investment (Second Edition)*

#### 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%	4.8%	0.6	14.8	2.5%
<b>Better Than Bonds/Utilities</b>	Utilities sector: natural gas, electric, telecom, and water	3.2%	7.0%	0.6	15.8	18.1%
<b>Distribution/Merging Utilities</b>	Local distribution utilities, takeover candidates	3.3%	3.9%	0.4	16.2	9.0%

as of December 31, 2005

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



PO Box 549  
Woodstock, NY 12498

Contact Information:  
Steve Chun  
schun@mhinvest.com  
www.mhinvest.com  
(888) 282-8845