STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS Autumn 2004

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 1,869.65 * Dow Jones Industrial 10,289.10 * Long-Term U.S. Treasury Bond 5.00%

ENERGIZED

Oil prices will fall. Dramatically. Yes, it's a good bet that the price of oil in 2035 will be much higher than it is today—because the world's population will be a third larger, and the powerful growth of the Asian nations will drive powerful growth in energy demand. But the spectacular rise of oil prices over the last five years has unleashed irresistable market forces that will sweep away speculators, shortages, and temporary disruptions overseas.

When the price of any commodity quadruples—and market participants become persuaded that the increase is here to stay—remarkable things happen. Most people still use gasoline as if it were free, and many will continue to do so even if the price goes to $5 a gallon. But some drivers began to cut back their fuel consumption (by driving less, or driving more-advanced vehicles) when the price of gasoline had only climbed 25 cents. More jumped on the bandwagon when the increase reached 50 cents, and many more joined the trend at $1.00.

That additional dollar goes directly into the pockets of foreign governments and oil companies. The economic impact is similar to a tax levied by those governments; a tax on the American consumer. In fact, OPEC occasionally complains that Europe's high gasoline taxes represent a direct transfer of wealth from Saudi Arabia, Iran, and Venezuela to the governments of Europe. American gasoline taxes do the same, and there is no question that an increase in our gas taxes would cause gasoline prices to rise, but cause crude oil prices to fall. As a nation we would benefit at the expense of the Saudis.

Consumption trends are only one side of the equation. Today's high oil prices are opening up old wells, and allowing many new technologies—and 1980s technologies—to become viable. Windmills are now producing power at competitive prices, nuclear is about to make a comeback, and new coal technologies will allow us to expand the use of our inexhaustible coal reserves.

Arnold Schwarzenegger has set a goal to have 20% of California's power generated from renewable sources by 2010, with a million solar-powered homes. He should get together with Konarka Technologies of Lowell, which is about to launch a line of solar roofing shingles on the theory that everybody needs roofing shingles to keep water out of the house. Those willing to pay up for the premium shingles will also get free electricity from them. And the DC power produced by solar is the right kind of electricity for your TV, your computer, and all other electronics. If we could eliminate their power-hungry AC-to-DC converters the nation's electric consumption would take a big step downward . . . .

Never, ever bet on a shortage in any commodity; oil, gas, copper, gold, silver . . . . remember when

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> "Strength Through Exhaustion"
>
> - David Brower's nickname for the notion that we can achieve energy security by increasing the rate of oil production in the United States. It's like pulling oil out of the Strategic Petroleum Reserve . . . .

Diamonds… *(continued from page 1)*

the Hunts tried to corner the market in silver? There's an important principle in economics which says that even a very small price increase will cause a reduction in consumption and an increase in supply. Somebody, somewhere, is always teetering on the edge of indifference to any given product, so the tiniest price increase will cause a consumer—some consumer—to consume less, even as a producer is encouraged to produce more.

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THE DECLINING DOLLAR

It's no more than a coincidence that we have a half-trillion-dollar budget deficit and a half-trillion-dollar trade deficit, but it's a BIG coincidence. Foreigners have been lending us huge sums to finance our hunger for imported goods, and for a time they were so eager to lend (and invest in the U.S.) that they pushed the dollar higher and higher. That rising dollar felt good—it boosted our economy and kept inflation down—but a high dollar is *not* a good thing (in the same way that rising debt feels good, but high debt doesn't . . . .).

Foreigners are running out of reasons why they should invest an additional $10 billion in the United States every week to keep our balance of payments balanced. The dollar will continue to decline, and the prices of imported goods will continue to rise. Foreign stocks might or might not be a good investment at a time when the dollar is falling, but foreign bonds will almost always give you good returns. With interest!

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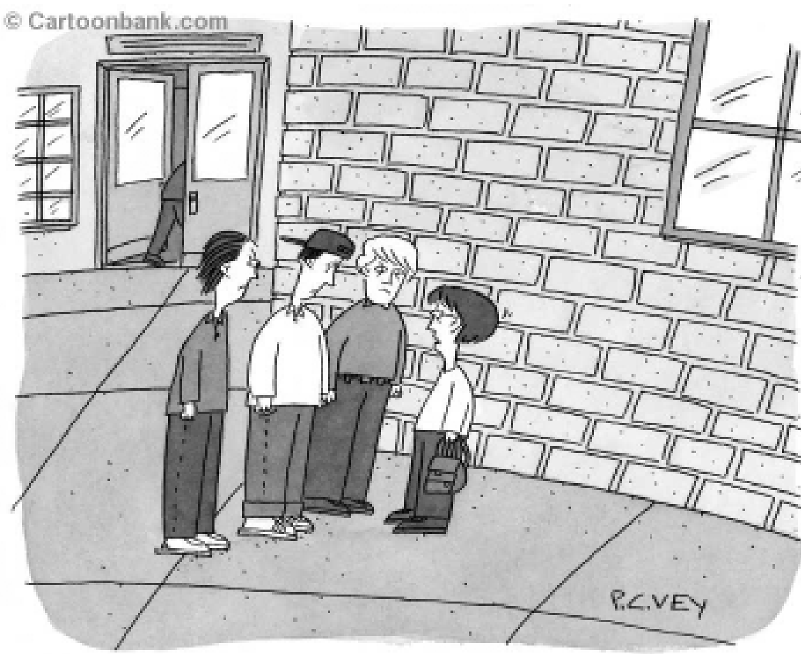

"All my lunch money's in real estate."

Robert J. Shiller, who famously published "Irrational Exuberance" just as the millennium bubble was about to burst, now says that there's a bubble in parts of the real estate market. He expects it to end with a whimper rather than a bang, and doesn't give a prediction for when that will happen. But those who lived in New England in the early 90s know that real estate markets can and do fall. Don't put any more into property than you have to.

KNOW YOUR TAX BRACKET

Tax rate	**15%**	**25%**	**28%**	**33%**	**35%**
Single	$7,001-28,400	$28,401- 68,800	$68,801- 143,500	$143,501- 311,950	over $311,950
Married, filing jointly	$14,001-56,801 Plus FICA!	$56,801- 114,650 Plus FICA!	$114,651- 174,700 Plus FICA!	$174,701- 311,950 Plus FICA!	over $311,950 Plus FICA!

FICA—the Social Security and Medicare tax—adds another 15.3%. Half is paid by your employer, if you're not self-employed. Those earning more than $87,000 pay just the Medicare component, at 2.9% .

WE JUST WANT TO PUMP YOU UP

It's been four years since the Millennium bubble burst. But the effects linger on, in a huge federal deficit and an unusually stimulative monetary policy from the Bubble Boys at the Fed. They're battling to keep the economy growing, and growth comes hard when you're trying to push above and beyond the artificially-inflated GDP of the biggest party of the last millennium.

At the turn of the century our economy was pumped up—via amphetamines and steroids and wild consumer spending—to such a high level that it became almost impossible for it to grow naturally in ensuing years. Internet companies created a new way to turn investment capital and nest eggs into GDP (just spend it!), and the rest of the nation set to work running up debt and running the savings rate down below zero.

By the end of the year 2000 our Gross Domestic Product had reached Ten Trillion Dollars. But common sense was sweeping across the country—everybody was spending less, and saving more—and we began to sink into recession. The Congress, afraid to allow even a middling recession to develop, stepped into the breach; jacking up government spending to a level that almost exactly compensated for the falloff in consumer and corporate spending.

The hard truth is that unemployment rises unless the economy grows by several percentage points each year. Now that GDP was at $10 trillion, we had to push it to $10.5 trillion and $11 trillion and $11.5 trillion to keep the unemployment rate from rising. Alan Greenspan did part of the heavy lifting by bringing interest rates down and encouraging consumers to quit saving money, and the Congress did the rest by running a $430 billion deficit. More amphetamines to pump us up!

A few years of slow growth can get us back on track. We *can* balance the federal budget even as consumers return to a "normal" savings rate, because the natural state of our economy is growth; yesterday's "overinflated" $10 trillion GDP looks like a very low number today. And there's no need to repair the balance sheets of our corporations, which have already reduced and refinanced their debt.

Still, the road could be bumpy. Consumers and the government are a couple of 900 pound gorillas, and when we ask them to balance their budgets without hurting growth we're asking them to dance together. Gracefully. It doesn't help that the Baby Boomers—a powerful force in the millennium bubble—have always moved as a herd. If we all become overexuberant or frugal at once, it will be hard for government to smooth the path of our GDP.

Investors, as always, need to maintain balance and be ready for opportunities. The most important factor in today's markets is the price level, because everything—stocks, bonds, real estate, and commodities—is fully priced. Keep some powder dry, because the markets will eventually return to their normal state of irregular and varied confusion.

If the Congress does try to balance the budget, it's not likely that they'll accomplish the task with spending cuts. Supply-sider Bruce Bartlett—former staffer for Jack Kemp, Ronald Reagan, and the Heritage Foundation—expects tax increases, because more than 80% of the budget has been declared off-limits to spending cuts.

Social Security and Medicare have ballooned to almost 50% of all government spending. Add in retirement plans, veteran's benefits, welfare programs, defense (which has shriveled from 51% to 16% of government outlays) and the interest on the government's debt, and you've totaled more than 80% of the budget. All the remaining programs—national parks and forest, highway boondoggles, farm pork, and everything else you can think of—account for less than $1 out of every $5 in the budget.

We can hope that they'll leave today's favorable dividend and capital gains tax rates alone. But it's certainly not too early to take capital gains at today's low tax rates—just 15% for most taxpayers, and an insignificant 5% for those in the 15% bracket!

From 1968 to 2000, credit card debt—adjusted for inflation—increased 6,000%.

— Yahoo!

John Lumbard, CFA

Photo by Rick Balboni

As of August 31, our benchmark account was up 237.37% from inception in 1990. If you would like to learn more about our performance record, fees, custody arrangements, or other details, please visit our web site, www.lumbard.com. Or, call Jan at (800) Lumbard and ask for a packet of our literature.

If you adjust for inflation, the peak oil prices of the early 1980s exceeded $70 a barrel. For the most part the price ran up quickly; but it then took 17 years to reach the inflation-adjusted low of about $12 a barrel. Oil doesn't have the impact on our economy that it had in the 1970s, but we'll still get a clear boost when oil prices decline.

WHEN TO SELL

Investors seem to feel very comfortable with the challenge of finding stocks to buy. If you feel uncomfortable with the—lesser—challenge of selling, try using these guidelines:

* Set a target for the size of the average holding in your portfolio. Our average common-stock purchase is about 2% of an investment portfolio, and we later use that percentage as a benchmark. If the stock doubles to 4% of the portfolio, we'll consider cutting back the holding, because our "bet" has just doubled.

Investors love a rising stock, but if you are in this situation and you don't sell any shares, you're making a statement that you think the company is twice as good as the others in your portfolio. If a double weighting is such a good idea, why didn't you load up on the shares before the big run-up?

* Sell if your company's competitive position has deteriorated, or you come to believe that your initial evaluation was flawed. But this blinding bolt of inspiration is most likely to strike when your stock has just taken a licking. If the company has lost half of its earnings power but the shares are down 75%, you should be buying, not selling. And take note of the fact that this stock has shrunk to much less than 1% of your account . . . . .

* Many investors use stop-losses, automatically selling any stock that falls 10% or 20% or some other predetermined figure. Don't even think of it. Your efforts to avoid the next Enron will cost you a small fortune, because stocks are volatile. Set your stop limit at 10% and you'll find yourself selling all your favorite stocks before they've had a chance to soar; set it at 25% and you won't sell as many, but you'll get a lousy price every time you sell.

* If now is a good time to sell, don't get hung up on the question of "what am I going to do with the proceeds?" The yield on money market funds is dismal, but that's not a reason to buy an overpriced—or even a fairly priced—stock with a 2% dividend. You're not planning to stay out of the market long enough that the yield difference is noticeable, and if the share price drops 20% (a very common occurrence for even the bluest of blue chips) you'll wish you had kept the money under your mattress. Wait for a good opportunity. Or a *great* opportunity.

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Profit margins are at their highest level since the 1920s. That's surprising and happy news; but it's also reason to expect smaller profit margins in the year ahead.

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That's (800) 586-2273.

THE GOLDEN YEARS

Corporations have been cutting back their pension expenses for years. Most have eliminated their defined benefit plans (the kind that promise to pay you a certain number of dollars per month in retirement) in favor of plans that are largely funded by employees. And most of the companies that still have defined benefit plans have fiddled and diddled with them to minimize the cost, and postpone contributions to future years.

They're also ignoring the cost of future health obligations. Investors in companies with generous benefit plans have good reason to worry that earnings have been temporarily inflated—sometimes to a large degree.

From an employee's perspective, these underfunded plans become a real threat if the employer begins to teeter toward bankruptcy. The U.S. government's Pension Benefit Guaranty Corporation provides assurance that benefits will be paid, but often at reduced levels. Neil George, editor of the newsletter Personal Finance (www.pfnewsletter.com), warns that many employees of bankrupt corporations—particularly those who earned good wages during their careers—are now receiving much less than they were promised.

Neil suggests that any workers (especially well-paid workers such as airline pilots) who are offered the chance to cash out of a defined-benefit plan should do so immediately. Today's low interest rates mean that you'll get a larger lump-sum payment than you would normally receive, and you'll be protected from the risk that a bankruptcy will reduce your retirement income.

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"Options are something people want and desire. When the company gives them away, the company is giving away something of value, and that is called an expense."

-From **Stock Options and the Lying Liars Who Don't Want to Expense Them.** Clifford S. Asness, Financial Analyst's Journal

The owners of a company should be allowed to vote on the size of the CEO's salary, bonus, and egregious options package. And they should have the opportunity to choose between *two* candidates for *each* seat on the board. Power to the shareholders!

"A million for you,
A million for me.
A million for you,
A million for me . . . ."

ELDER BOOMERS

In the 300,000 years since humans first walked the face of the earth, mankind has had lots of workers and very few retirees. That's about to change.

Lifespans have increased dramatically, and a huge number of Baby Boomers will soon start dropping out of the workforce and onto the Social Security rolls. "Soon", in this context, is 15 or 20 years from now; but this is no small thing. If we have lots of retirees and few workers, who will serve the hamburgers and change the bedpans? Plumbers and electricians will make $350 an hour, while us old folks eat canned beans in the dark . . . .

"If lawyers are disbarred and clergymen defrocked, doesn't it follow that electricians can be delighted, musicians denoted, cowboys deranged, models deposed, tree surgeons debarked, and dry cleaners depressed?"
—George Carlin

. . . . .Fund managers who are caught trading against their shareholders are *disappointed.* If you pull your revocable trust out of the care of a bank you might say it's distrusted . . . . .

On the other hand, ever since the Industrial Revolution economists have worried that rising productivity puts people out of work. Today less than 2% of our population is employed in agriculture, in sharp contrast to the rest of human history; in which nearly everybody was needed to produce food for the table. We no longer have a need for many manufacturing workers, or low-level office workers. Perhaps these trends can cancel each other out . . . .

It's almost impossible to forecast the future accurately—our economy is a complicated beast—but that doesn't mean that we can afford to be irresponsible. We need to maintain the political will to 'do the right thing' even when it means a bit of short-term discomfort.

It's possible that we can afford to increase the per-person cost of Medicare and Social Security each year, but we might find that later there's a big price to pay. It's possible that we can afford to run big deficits in the federal budget, but it's a risky strategy. And it's possible that we can absorb and give amnesty to waves of middle-aged illegal immigrants, but we might later find that they add a great Social Security and Medicare burden at a time when we can least afford it. Do we really need cheap lawn care and 99-cent-a-pound table grapes today?

The best strategy would be to balance our budgets and use conservative assumptions when planning for the future. Reduce the waves of immigration to a trickle, and then open up the floodgates—for skilled workers—fifteen years from now. That way we give today's unskilled Americans a chance to earn a decent wage, we put the brakes on suburban sprawl, and we ensure that there will be enough workers to keep the lights on and the toilets flushing for the impoverished old Anglos of the future.

Investing, like government, is an uncertain process with long time horizons and serious consequences for failure. So always try to take the high road. Avoid the temptation to invest for maximum income or maximum growth (or maximum income *and* maximum growth) . Diversify among growth stocks, income stocks, blue chips, bonds, and other categories. Pay attention to dividends and interest payments that give you a tangible and dependable return today. Never allow a single stock to grow to 10% of your portfolio. Buy low and sell high; adding to stocks that go down, and selling part of holdings that go up. Be frugal. Don't dip into principal. Don't run deficits. It's OK to dream of bountiful harvests, but make sure you've stored enough acorns to get through the winter.

– John Lumbard, CFA

Performance Results:
The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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