LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,087.91 * Dow Jones Industrials 10,558.00 * 30 year U.S. Treasury Bond 4.74%

BULLDOZERS

When you think of lifetime love affairs with common stocks, the first names that come to mind are Warren Buffett and Coca-Cola. KO first swept him off his feet back in the days when it was a modest-sized company with a well-honed, repeatable business that was perfectly positioned to ride one of the big waves of American culture. Our population was growing, and the per-capita consumption of sugar and soft drinks was growing by leaps and bounds. The Coca-Cola Company could grow at a good rate if it simply kept its share of the soft drink market.

Of course, Coke was also well managed—and it recognized that the same opportunities existed around the globe. The resulting period of steady growth spanned decades, and elevated the company to a special position on Wall Street.

From there, the story was twisted into the usual caricature of overblown expectations, an overblown stock price, and world-class hubris. In the late Nineties one of the company's annual reports suggested that soft drinks would replace orange juice in the morning and fine wine at night. But until then Coke bulled its way to greater heights while its shareholders dozed. Every sensible investor wants that sort of bulldozer, with steadily-growing earnings and dividends. A stock to have and to hold, in good times and bad, until death do eliminate all capital gains taxation.

On the day when trading resumed after 9/11/01 we purchased shares of Avon Products, and since then we've been continually impressed with the company's bulldozer growth. Avon (AVP - $40) is a high-status brand in emerging markets, producing sizzling growth rates in Eastern Europe, Asia and Latin America. Two-thirds of the sales are overseas; if the dollar falls or the Third World continues to rise, Avon should have no trouble growing at consistent double-digit rates.

This past autumn, when stocks were sliding, we added two other stocks with much better dividend yields. Conagra (CAG - $28) is a packaged-food company that recently sold off its many commodity businesses to focus on branded products that offer the potential for stable growth. The stock pays a healthy 4% dividend, so the shares don't have to rise very quickly to give you a good, tax-advantaged return.

A.J. Gallagher (AJG - $30) offers a good dividend *and* a good growth rate *and* an attractive price. But there's no such thing as a free lunch; buyers have to be willing to shrug off the Marsh & McLennan scandal that has tainted the entire insurance-brokerage industry in which AJG competes. If you can get past that bundle of worries (the CFO swore to us that he has seen no evidence of bid-rigging), you'll find that the company is picking up brokers and customers from its wounded competitors. And you'll get a dividend of more than 3% while you're waiting for the company to clear its name.

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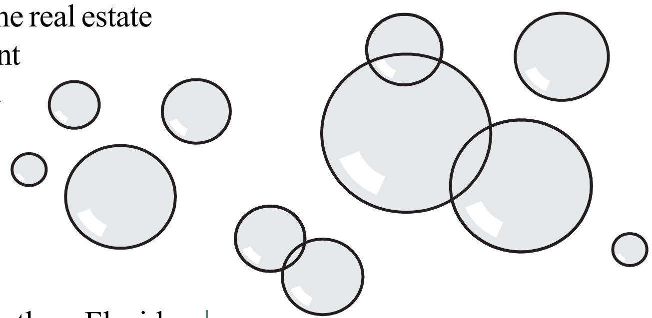
Two-thirds of all the people in world history who managed to live past the age of 65 are alive today.

THE REAL ESTATE BUBBLE

There is a bubble in the real estate market. It's translucent and tumid. Bloated and bright. Robert Shilling says so. Even the Fed is talking about it!



No market is hotter than Florida, which seems to be trying to re-enact the land rush of the 1920s. Our own John Convery has been observing the frothing frenzy at the front lines in fabulous frost-free Florida, where 1,200 people recently applied to buy 125 condominiums slated for construction in a new ten-story building. The buyers only have to put down 5% of the purchase price of a condominium to claim ownership, and the word on the street is that many—or even most—of the buyers are speculators hoping to sell at a big profit when the building is completed 6 months hence. The profit could be several times the size of the deposit, and their potential losses are limited. It's way more fun than buying lottery tickets . . . .

Meanwhile Paul Wright, another investment advisory board member, darkly suggests that the nation's builders are building too many homes, and buying *way* too much land. For those who assert that "real estate never goes down" he offers up the 13-year decline of Japanese land prices, and the 30% decline of home prices right here in New Hampshire in the early 1990s . . . . . When the speculators stop buying homes and the developers stop buying land, the great suburban-sprawl machine will grind to a halt.

John and Paul differ in their expectations for the bursting of this bubble. John believes that the impact on the broader economy will be muted, because other industries will begin to pick up steam. Paul feels that the event will happen soon—as early as the second half of this year—and that repercussions in the appliance, building-materials, carpeting, and furniture industries will combine to cause our next recession.

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Our last issue quoted George Carlin, who asked "if lawyers are disbarred and clergymen defrocked, doesn't it follow that electricians can be delighted . . . cowboys deranged . . . and dry cleaners depressed?"

Two readers responded, suggesting that teachers could be "detested".

Plumbers "dethroned".

Mozart, Beethoven, and Brahms:
Decomposing . . . .

OTELCO

The best and biggest cash-in-your-pocket opportunity of the last year came to market in late December, slipping softly past the radar screens of investors and the media. It's a small rural telephone company named Otelco (OTT - $15), which serves customers in Missouri and Alabama. Like other telephone companies, it's managing to keep revenues and earnings from shrinking (despite a slow decline in local telephone service); by adding DSL, long distance, call waiting and other services.

The chief financial officer, Curtis Garner, described the business as "boring". But his description was far from pejorative; he used it in response to our question about Otelco's ability to continue paying out huge dividends and interest payments to shareholders. There was nothing boring about the company's initial public offering, a unit comprised of a share of common stock and a bond, that will produce 70 cents of dividend (taxed at a maximum rate of 15%) and 98 cents of interest. At our purchase price the total yield was 11%.

This "Income Deposit Securities Trust" concept celebrates shareholders rather than the CEO, and pays all the profits of the enterprise right out to them. We think that's a great idea, but don't buy just because the yields look big. Do your homework and make sure that the company has a good chance of continuing to pay big dividends in good times and bad.

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BLOAT

Size matters. The bigger the company, the slower the growth rate—and the more likely it is that management will get bogged down with bureaucracy, greed, and hubris. America Online, Lucent, Nortel, Kodak, Xerox, Worldcom, Enron . . . . Wall Street is littered with failed corporate icons.

Market capitalization—the total value of the company's shares—also matters. Even now, after a year of shrinkage, the market value of Pfizer is $200 billion. How many blockbuster drugs will Pfizer need to introduce each year to maintain that level, let alone grow?

Another one to watch is Wal Mart, a stock which has been declining for years in the face of strong growth. The price was far too high—picking a good company is *not* enough—and today some investors are beginning to sense that the company is too darn big. It's not just the weight of bureaucracy; it's also the simple fact that the company has to add 75,000 employees and $17 billion in sales to grow just 5%.

And Wal-Mart has another big problem. After a brief fling with a "Buy American" campaign, the company fiercely embraced a "Buy China" policy, and began browbeating Chinese manufacturers to produce knockoff goods at ever-lower prices. WMT hasn't made many friends among its worldwide suppliers (or the companies whose products it copied), and it will have no place to turn for relief when the Chinese yuan starts rising. It's entirely reasonable to imagine that the price of the average Wal Mart trinket will rise by 20% or 30% in the years immediately ahead.

Consumers must know this, because they've been filling their attics with cheap imported goods as if they were stocking up ahead of a famine . . . .

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SNAKE OIL

Politicians have been gleefully jumping onto the "buy cheap drugs from Canada" bandwagon, but the band and the parade will pack up as soon as they get to the edge of town. There is no chance that the pharmaceutical companies will be willing to sell Canada (population 32 million) enough drugs to serve 320 million people.

What Washington *should* do is talk up the attractions of off-patent medications. Many of these drugs—the latest and greatest treatments of the early 1990s—are every bit as good as the pricey pills that everybody wants.

You'll never see a Super Bowl ad from a generic drug manufacturer, but we're not talking about Gucci handbags here. We the taxpayers (and We the buyers of medical insurance) are paying for these extravagances. 1990 medicine is good enough for the vast majority of pharmaceutical needs, and our government should be spreading that message far and wide.

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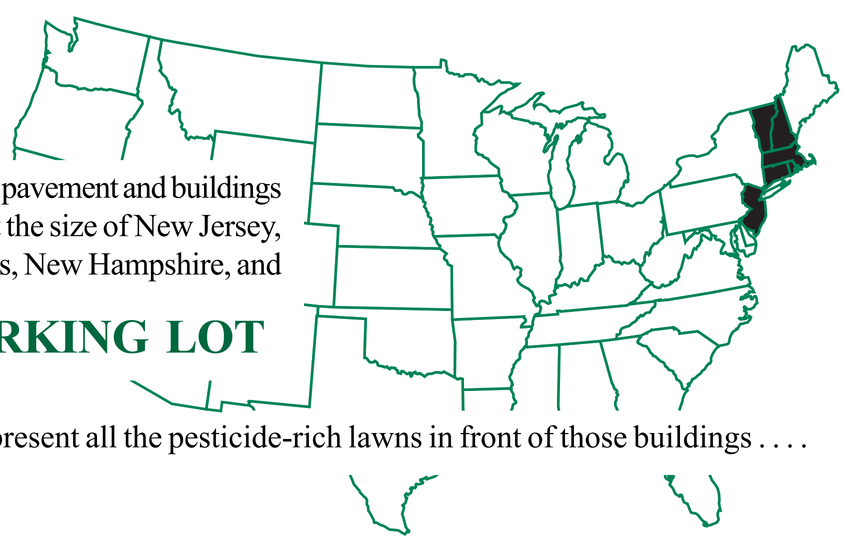
THEY PAVED PARADISE



Harvard professor Richard Forman says that the pavement and buildings in the United States would cover an area about the size of New Jersey, plus Connecticut, Rhode Island, Massachusetts, New Hampshire, and Vermont.

AND PUT UP A PARKING LOT

You can add in a couple of larger states to represent all the pesticide-rich lawns in front of those buildings . . . .

John Lumbard, CFA

Photo by Rick Balboni

In 2004 our client accounts continued to grow, fueled by dividends, interest, and capital gains. Our stock picks performed very well, and we got another big boost from the foreign government bonds that tormented us during the bubble years. The "benchmark" account that we've been tracking since 1990 finished the year at $366,179, up from $100,000 at inception.

If you'd like more information, visit www.Lumbard.com, or call us, at (800) Lumbard, and we'll send our literature by mail. That's Lumbard, not Lombard! (800) 586-2273.

A rising dollar is a good thing. It reduces inflationary pressures (because it causes a decline in the price of oil, other commodities, and all imported goods); and lower inflation means lower interest rates that help economic growth. A rising dollar also attracts investment from overseas, and that influx of cash pushes down interest rates even further.

But a *high* dollar is a bad thing. It destroys our manufacturing base, and harms anyone—farmers, manufacturers, software designers—trying to compete with overseas rivals.

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A study conducted by 12 research groups in seven countries concluded that the electromagnetic fields produced by cellular phones cause "a significant increase in single and double-strand DNA breaks." This does not prove that mobile phones are a risk to human health, but it's hardly a ringing endorsement . . . .

FINANCIAL PLANNING CORNER

If you plan to leave money to charity on your death, leave IRA assets rather than other funds. The charity won't have to pay taxes when the funds are withdrawn from the IRA . . . . .

If you believe (as we do**!**) that tax rates will rise in the future, Roth IRAs look sweet . . . . Sherrill St. Germain of New Means Financial Planning, here in Hollis, says that it's still possible to convert a regular IRA to a Roth. The taxes you pay in the conversion can come from *outside* the plan. And there are no mandatory annual distributions from a Roth IRA.

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A falling dollar is a bad thing. But a *low* dollar is a good thing . . . .

LAND. THEY AIN'T MAKIN' ANY MORE OF IT.

Land prices in Japan rose about 95% between 1981 and 1991. There's nothing spectacular about that. But they gave up the entire increase—falling all the way back to the 1981 level—in the 13 post-bubble years between 1991 and 2004.

Give us a call at 1(800) Lumbard. **Not** (800) Lombard**!** (800) **Lumbard.** That's (800) 586-2273.

HIGH ON FINANCE, CRAZED WITH CREDIT

Financial companies—banks, insurance companies, and brokers—produce about 40% of all corporate earnings. Those earnings have been greatly aided by the long years of cheap money (low short-term interest rates) that we've experienced since our last recession in 2001. Rising interest rates will have the opposite effect. And there are other concerns.

One is the startling growth and scale of credit-card debt. Huge numbers of consumers are leveraged to the point where they'll find it hard to cope with a job loss. And the current policy of most lenders is to sharply ratchet up the pain of a job loss by raising the interest rate on credit-card debt to loan-shark levels of 20%, 30% or more. Meanwhile, homeowners have been allowed to ratchet up their mortgages to 95% of peak value. It's not hard to imagine a very ordinary downswing in the business cycle, in which a million households take advantage of today's liberal bankruptcy laws. Shedding the house and the credit cards in one fell swoop.

The other big concern is financial fraud. The Internet has opened new worlds to white-collar criminals, allowing them to set up automated operations on a massive scale with little risk of getting caught. Criminals in Russia or Saudi Arabia can intercept e-mails to harvest passwords and sensitive financial information; they can use huge volumes of clever, targeted spam to lure willing victims; and surreptitiously recruit faraway PCs by the tens of thousands to crack codes, break through firewalls, and search for data that will aid identity theft or other crimes.

Your own PC might already be involved. Never open e-mail from strangers, and be suspicious of any e-mail that claims to be from a bank. If you haven't yet purchased an anti-spyware program, do so immediately. These measures can keep your PC safe, but the banks and other financial companies are sure to suffer big losses from the new era of credit-card and wire scams.

"A recent Yale University study reports that the school emits more greenhouse gases than 32 developing countries, with 84 percent of emissions coming from on-campus power plants."

— the Appalachian Mountain Club's AMC Outdoors magazine.

According to the Department of Transportation, SUV occupants are 11% more likely to die in a crash than are people in passenger cars. Pickup trucks are worse . . . . either will pump 7.5 tons of carbon dioxide and monoxide into the air in a year, assuming just 10,000 miles and 12 miles per gallon . . . . .

According to the Social Security Administration, there are 76 million Baby Boomers. That's a quarter of the U.S. population, and we're all going to retire in a couple of decades. Who is going to keep the toilets flushing and the lights on? Who will change the bedpans, and how much will we have to pay them to do it? And who, in heaven's name, is going to pay the taxes?

Stocks opened the New Year on a sour note. That's because—despite what you've heard from Wall Street forecasters who are paid to be bullish—the stock market is neither "fairly valued" nor "undervalued". An apples-to-apples comparison shows that today's price-earnings ratio is 40% to 50% higher than the long-term average. It's now as high as it was at the peak of the millennium bubble, if you use Value Line's 1,650–stock tally.

SEC rules, thankfully, are long on substance and short on red tape. One exception is the requirement that each year we offer part II of our form ADV to clients and prospective clients. The form is remarkable in that it contains little information that anyone would find useful—but the SEC requires that we offer it in writing, and that you respond in writing to request a copy. We'll send you one even if you just call on the telephone. Call us at (800) Lumbard, which works out to (800) 586-2273. That's Lumbard, not Lombard. (800) 586-2273.

SEVEN SURPRISES

Last January we published a list of forecasts for 2004. Alan Greenspan did indeed begin to take his foot off the gas—allowing interest rates to rise— but the US economy grew faster than our moderate expectation. Wall Street *was* disappointed by the growth of high-tech companies. And the Wall Street Journal reports that the market for oversize homes *has* been at a standstill since June.

The dollar fell against the yen and other currencies, but did not stabilize against the euro. Terrorists continued to focus their fury on Iraq rather than the United States—still no terrorist events here since 9/11—but investors never did focus much fury on the mutual fund industry. Worst of all, Osama bin Laden has apparently not died of natural causes.

For 2005, we'll predict an end to the Mini-Me Bubble that pushed up real-estate prices in the United States—and stock and bond prices around the world. We'll also have another go at predicting that the dollar stabilizes against the euro but continues to fall against the Asian currencies. One of the big, unnoticed stories of the last two years has been the dramatic, illogical decline of the Chinese yuan in relation to the euro; you *know* that the Europeans are exerting intense pressure on the Chinese to revalue. As the yuan rises (gradually, in stages) the other Asian nations will allow their currencies to rise with it.

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YOU'RE FIRED!

Why would anybody want to work for Donald Trump, or invest in a venture run by him? In November his casinos filed for Chapter 11 protection from creditors—again—yet the guy with the funny hair will still be in control of the failed venture when it emerges from the federal bankruptcy courts. And the wedding bells started ringing again the moment he emerged from his latest visit to the divorce courts. . . . .

The Donald's talent for self-promotion brings to mind a slew of superstar CEOs, from Michael Armstrong of AT&T to Bernie Ebbers of Worldcom; from Jeffrey Skillings of Enron to Dennis Kozlowski of Tyco International. In many ways Kozlowski was the King, calling on the investment bankers enriched by his 800 acquisitions a year to help him climb onto Business Week's list of the nation's Top 25 CEOs.

It takes a lot of news to feed the media beast, and it takes a lot of fat deals to feed the hunger of Wall Street's investment bankers. Superstar CEOs know how to play the game, providing deals and news in return for acclaim and ever-increasing pay packages that feed their oversized egos. They also know how to give their shareholders wings, and help them loose the bounds of common sense . . . Investors should try to avoid charismatic leaders, "great" managers, and bold, decisive visionaries.

You should also avoid the stocks of companies that make trophy acquisitions. An obvious fact, often overlooked, is that it's always better to have your shares *acquired.* It's the "loser" in the takeover battle, the little company with the shy (and retiring) CEO, that rewards its shareholders with a big cash payday. Real leaders shun the limelight, give all the credit to their employees, and focus on the tasks at hand.

John Lumbard, CFA

WHISTLIN' DIXIE

Why does the press always describe Saddam Hussein's thugs as "rebels"? Next thing you know they'll be filing their stories from "the Land of Cotton", where the old-time Rebels protected their crops with mustard gas . . . . Old times there are not forgotten . . . Hitler's thugs never got that kind of positive spin, even after American troops laid waste to their bucolic fatherland . . . . CBS has purchased Confederate uniforms for the Rebels . . . . snappy Legionnaire uniforms for Zarqawi's Freedom Fighters . . . Stay tuned for a retrospective on "Saddam's Search for God."

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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