

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,068 * Dow Jones Industrial 10,510 * 30 year U.S. Treasury bond 5.01%

SEVEN SURPRISES OF 2004

At the beginning of each year Byron Wien of Morgan Stanley gives a list of "Ten Surprises" for the year. Unhappily, his 2004 list was actually TWO lists; one with bullish predictions and one with bearish predictions. "Better safe than sorry" is not the best motto for a pundit, so we'll take a stab at a few predictions that have a genuine potential for error. Feel free to highlight all our mistakes at year-end.

- 1) A very moderate surprise. The American economy grows, but at a moderate pace.
- 2) The dollar stabilizes against the euro, but continues to fall against the yen and other Asian currencies. When the dust finally settles the world's currencies have all returned to their 2001 levels—except that the dollar is sitting at 20-year lows. Foreign investors, mindful of the continuing decline of the dollar, stop buying U.S. Treasuries, dollar-denominated corporate bonds, and American stocks. Interest rates rise.
- 3) The revenues of high-tech companies grow at old-economy single-digit rates, despite the

emergence of several legitimate candidates for the long-awaited "killer application". Investors begin to demand tighter, tougher accounting for stock options and write-offs.

4) Terrorists continue to focus their fury on targets in Iraq rather than in the United States. Intelligence experts uncover evidence that Osama Bin Laden died of natural causes.

5) The market for oversize homes falls victim to oversupply, higher interest rates, and high expenses; huge real-estate tax bills, maintenance bills, and heating bills. Baby-Boomers built the McMansion boom, but now that they've arrived at the empty-nester stage they are realizing that they have more space than they want to heat, clean, and maintain.

6) The mutual-fund scandal fades into memory, but investors begin to feel disenchanted with mutual fund performance and fees; management fees, 12b-1 fees, other marketing expenses, legal fees, insurance costs (yes, these are paid by investors), soft dollars paid to brokerage firms, withdrawal fees, and sales commissions.

7) Alan Greenspan takes his foot off the gas.

The markets have pushed relentlessly higher because the Fed printed a lot of money and drove interest rates to zero. Investors can't bear to leave cash in money-market-funds at near-zero interest rates, so they're constantly looking for alternatives—with little regard for valuation. It's the **Mini-Me Bubble**, and it has pushed up prices in the stock market, the bond market, the real estate market, the precious metals market, and all other commodity markets. The dollar has fallen against all of these things, just as its value has fallen against the euro and almost every other currency in the world. This debasement of the dollar has to stop, and it *will* stop; the moment the bubble-boys at the Fed lose their fear of a Japanese-style post-bubble recession.

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" it's impossible to boot a negligent board. The typical American corporation is a shareholders' republic in the same way that China is a people's republic."

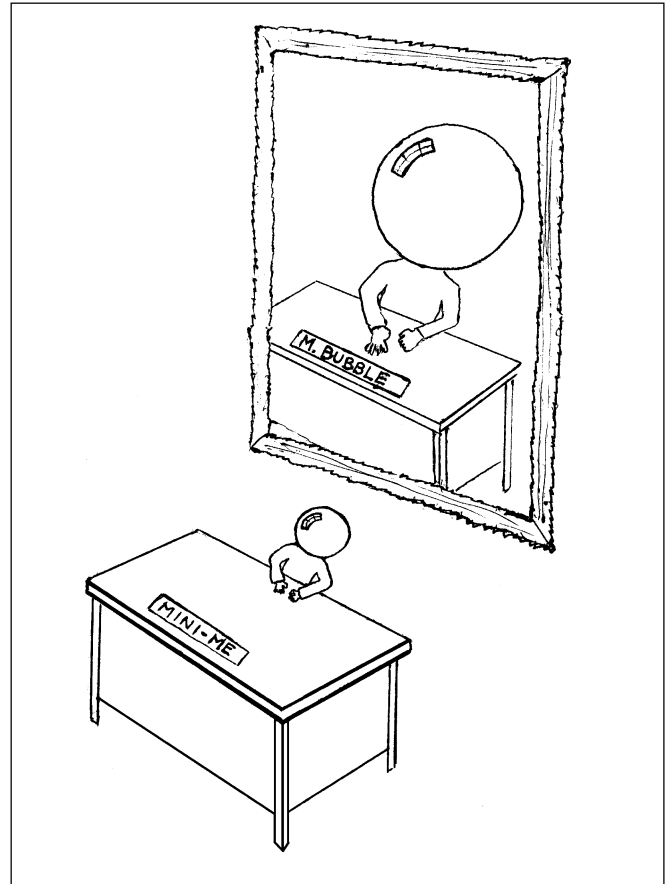
— James Surowiecki,
The New Yorker

“It seemed at that time as if the whole nation had turned stock-jobbers. Exchange Alley was every day blocked up by crowds, and Cornhill was impassable for the number of carriages. Every body came to purchase stock. Every fool aspired to be a knave”

— Charles Mackay,
writing about the epic bubble in the shares of the South Sea Company in 1720, in his 1841 classic, Extraordinary Popular Delusions and the Madness of Crowds

“Age is too high a price to pay for maturity.”

— the monthly newsletter of the
Old Capital Club of Monterey (CA).



The Mini-Me Bubble

A YEN FOR FOREIGN CURRENCIES....

An important part of our gains in 2003 came from the spectacular appreciation of the euro, and the additional appreciation of European bonds as European interest rates declined. We made a large investment in the euro (and a smaller investment in New Zealand bonds) because it seemed inevitable that the weight of our foreign trade deficit (and an excess of dollars in the world) would cause the dollar to slide. Investors would look for a large, safe, “plain vanilla” currency as their first alternative.

It’s possible that the euro will rise further, but we’re moving on. The dollar should now decline against the rest of the world’s currencies, to bring

everything back into balance. At the moment the business and political leaders of Europe are in shock, because currency movements have caused the already-low manufacturing costs of the Asian countries to decline even further.

The wildest and wackiest currency of all is the Chinese yuan, because constant government meddling in the currency markets keeps the yuan anchored fast to the dollar. The result is that the yuan—an obvious candidate for World’s Strongest Currency—has collapsed against the euro, and fallen against just about everything else.

The Japanese have been the most upset, and they’ve responded with massive, unprecedented action; purchasing dollars by the hundreds of billions to try to keep the yen from rising against the dollar, and thus the yuan.

But does that really make sense? Currency manipulation almost always fails in the end, and they’re not even manipulating the right currency! Rather than spend tens of trillions of (newly printed) yen on dollars, Japan should buy yuan. Or—better yet—quit trying to manipulate the currency markets, and pressure the Chinese to do the same.



WHAT TO BUY NOW

Our recent purchases have included an emerging-markets bond fund, on the expectation that the dollar will continue to decline. The fund pays 6%, so there's no need to hit this ball out of the park. We also hedged against rising U.S. interest rates with a fund that goes up when bond prices go down, and we bought a couple of Asian stocks which are available as American Depository Receipts.

Honda (HMC, \$21 per share) is a very familiar name, and with good reason. The company has consistently grown its market share in American automobiles, while pushing into lawn mowers and snowblowers and emergency electric generators. The company also makes noisy and annoying recreational vehicles such as ATVs and "jet skis", but balances the scales with environmentally-friendly four-stroke engines, fuel-efficient motorcycles for the Third World, and cars with hybrid drive systems.

The vast majority of the profits come from the U.S. automobile operation, whose local manufacturing operation is large enough to qualify Honda as an "American manufacturing company". That's a good thing to be, at a time when the dollar is falling, and Honda is one of the most-innovative and skillful manufacturers we have. Given all that, the stock is a bargain at 10 times earnings. Investor relations explains the low price by noting that the Japanese investors who dominate trading are still expecting to see the U.S. economy—and Honda's American sales—settle into a Japanese-style post-bubble funk that

goes on for a decade. Any investor who disagrees should buy the shares.

Korea Electric Power (KEP, \$10) is even cheaper. You won't find the company in Value Line, but it's a large, fast-growing electric utility that sells at barely more than 5 times earnings. One reason for the low price is that the (South!) Korean government owns 54% of the company. It wants to sell a good part of its shares, but has cancelled several auctions in response to poor market conditions.

In fact, the entire Korean market is cheap, and foreign investors find it so hard to buy shares that they won't be driving it up any time soon. KEP—the company's New York Stock Exchange ADS—sells at a premium to the shares in its home market, and the company is studying the ramifications of arbitraging the markets by repurchasing common and issuing more ADRs.

We told them that the result would be a surge of American interest. Over the course of the past five years the company's revenues are up 50%, earnings have doubled, and dividends have grown 78%. The dividend yield is only 3 ½%, but this is the kind of situation where the company *should* keep the dividend low. Power demand in South Korea is growing rapidly, so Korea Electric Power should continue to reinvest its earnings in new power plants that will bring future growth.



CHARITABLE REMAINDER TRUSTS

For nearly a decade we've managed a Charitable Remainder Trust for a married couple, and the experience has been so good that it's worth mentioning. The trust was funded by appreciated stock—stock which couldn't be sold without triggering a big capital-gains tax. That problem disappeared when the shares were placed into the charitable trust, because their cost basis immediately jumped up to current market values.

Eventually, all the trust's assets will go to charities chosen by the clients. But throughout their lifetimes they receive an income of 8%, which is taxed more-or-less the way an individual's income is taxed; with capital gains, interest income, and the new, favorable dividend rate. In today's low interest-rate environment the IRS will no longer allow an 8% payout, but the rates are always attractive. Call your attorney or financial planner for more details.



For many years the overarching goal—the corporate mission—of most public companies was to beat Wall Street's quarterly earnings estimate by a penny. The markets eventually caught on. Today the goal is to beat the estimate by two pennies

NUTS AND BOLTS

As we went to press we still didn't have performance numbers from some of our custodian banks, but it's clear that we had a good year. Our "benchmark" account ended the year at \$321,371, up from \$268,904 the previous year, and up from \$100,000 in October of 1990. The account has never had any additions or withdrawals other than our fees.

Lately we've been trying to slow the growth of new account relationships, so that we can continue to offer excellent client service and performance. One way to do that is to increase the minimum size of new accounts. That figure now stands at \$400,000, and we'll probably continue raising it each year until we can afford to bring in another portfolio manager.

Our fee for the first \$500,000 in assets is 1.1%. The percentage declines as the account size decreases, just as with any other investment management firm. What is not the same is that those fees cover the cost of custody at U.S. Bank, a super-regional with the capability to handle the German Government bonds and other off-the-beaten-path investments that were so profitable for us last year.

If you'd like to learn more about our firm, visit www.lumbard.com, or call Jan at (800) Lumbard and ask for a packet of our literature.



John Lumbard, CFA

Photo by Rick Balboni

"Worry is the misuse of your imagination."

— Ed Foreman, Executive Development Systems

THE LOWEST TAX RATE YOU'LL SEE IN YOUR LIFETIME

Don't be afraid to pay capital gains tax. Today's 15% rate on long-term capital gains is the lowest tax rate you'll see in your lifetime. The rate is an incredible 5% for taxpayers in the 15% bracket.

Those rates are so low that you should ignore them. If you don't like the prospects for one of the companies you own or you think that the stock is overpriced, sell it. Pay the tax and smile; because an unrealized, theoretical gain just became a

realized, real gain. And you'll never have to worry about future changes in tax rates.

"Today's 15% tax rate on long-term capital gains is the lowest tax rate you'll see in your lifetime."

Short-term gains—on securities held less than a year—are a different story, at least for investors in high tax

brackets. If you're going to have to give more than a third of your profits to Uncle Sam, you need to be very, very sure that the gains will slip away if you don't act *right now*. Those circumstances will arise, but those who make a habit of taking short-term gains have the odds heavily stacked against them. Day traders come to mind . . .



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

SELL MERCK AND PFIZER. BUY SCHERING-PLOUGH.

Eighteen months from now the talk of the party circuit will be the dangers of Lipitor. Like other statins, the drug has enormous benefits that vastly outweigh its shortcomings, which include muscle soreness and, less-frequently, muscle damage. But those risks are small in comparison with the dramatic effect that Lipitor has on cholesterol levels.

In fact, the biggest problem with Lipitor is that it can be *too* successful at lowering cholesterol. Your muscle cells actually *need* cholesterol, and—unlike other cells—they can only get the cholesterol they need by manufacturing it. They can't take cholesterol out of your bloodstream, so they can't take advantage of all the cholesterol in the junk food that you've been eating for health reasons. If a high dose of a statin prevents your muscle cells from manufacturing cholesterol, they will die—and don't forget that your heart is a muscle. Recently Bayer had to withdraw its new statin from the market, after numerous deaths from this muscle-wasting phenomenon known as rhabdomyolysis.

That fancy name will be well-known to the party circuit, because there's a new Schering Plough/Merck drug on the market that side-steps the problem. And there's an army of drug salesmen and scientists who will be happy to spread the word.

The drug, Zetia, reduces the amount of cholesterol that's transferred from your food to your bloodstream. A patient taking Zetia and Lipitor

together—happily, they *can* be taken together—is able to reduce his Lipitor dose and eliminate worries about muscle damage.

But patients who are new to cholesterol drugs won't be swallowing many Lipitor tablets. Their doctors will instead prescribe a combination tablet that marries Zetia with Zocor, a Merck drug that is Lipitor's biggest competitor. The new combination tablet (probably sold as "Zocor Plus") will benefit both doctor and patient, because they'll eliminate the need for the costly, time-consuming blood tests that guard against a statin overdose. The result? Lipitor will stop gaining market share, and probably decline.

Merck and Schering-Plough will equally share the profits from Zocor-Zetia. But the only clear winner here is Schering, which stands to reap half the profits from the hottest new drug of the decade. Merck is being forced to replace its 100%-owned crown jewel—Zocor is the source of a quarter of all its hefty profits—with a 50%-owned drug, because Zocor's patent will soon expire. By then Merck hopes to have Zocor-Zetia so firmly entrenched that plain ol' Zocor is just a dim memory.

Zetia is already on the market, and FDA approval for the Zocor-Zetia combination is only a few months away. Expect massive advertising, a slew of scientific papers, and articles in the "Health" section of every newspaper in the nation. Expect to

see armored cars lining up to take billions of dollars out of the coffers of Merck and deliver them to Schering. Expect to see the huge market capitalizations of Pfizer and Merck dwindle, while Schering Plough rises from the ashes.



STAYING THE CURSE

Mutual fund investors tend to buy funds with good performance (those that have gone up a lot recently), and sell those with bad performance (those that have gone down a lot). In other words, they buy high and sell low.

The results have been terrible, and they've been particularly bad for investors in common-stock funds. According to a study by Dalbar, Inc, the average stock-fund investor experienced an actual return of just 2.6% per year during the years 1984-2002; a time when the S&P 500 returned an above-average 12.2% per year.

When picking a mutual-fund manager or an investment adviser, look at long-term performance rather than the last two or three years. And once you've made your decision, stick with it until you've seen the manager's performance in up markets and down.



POWER TO THE SHAREHOLDERS

It's proxy season; a time when shareholders put forth proposals for better corporate governance, and CEOs swat them aside.

Management has a huge advantage in these contests. It's very, very difficult to ram through a proposal against the wishes of the CEO and his buddies on the board, most of whom are lifetime members of the CEO union. So follow our simple rule: when in doubt, always vote against the recommendation of the directors. If you want to express your support for a CEO, send him flowers. Or a bulletproof vest.



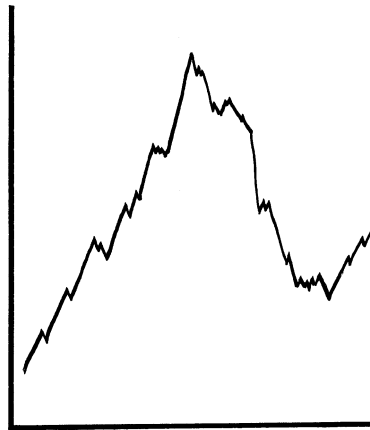
Several California Congressmen (fueled by tech-industry donations) have repeatedly quashed attempts to fix the spurious accounting rules that relate to stock options. They argue that honest accounting could cause a decline in stock prices, and that a decline in stock prices could send the economy into a downward spiral

The rest of us are leery of the notion that the nation can be well-served by a lie.

AVOIDING THE HERD

Stock market pundit Mary Farrell recently published a report on the wisdom of "selling your losers". Her staff analyzed the performance of 143 stocks that had declined more than 90%, and found that few of them ever regained their old highs.

True, but Farrell is asking the wrong question. Suppose she purchased a stock in the early 1990s, rode it up to a price of \$100 per share, and then rode it down to \$7. Rather than ask



"will this loser ever get back to \$100?", she might consider asking whether this "loser" will outperform the stock market in the future. Not from a price of \$100, but from *today's* price of \$7. That's the only price that matters.

When a \$100 stock drops to \$7, it's down 93%. If it then crawls back to a miserable \$14, it will have gained 100%. *One hundred percent.* Even a ho-hum trading range, from \$30 to

\$20 and back, offers an opportunity for a 50% gain for those who buy at the bottom.

In fact, a chart provided by Mary Farrell's staff clearly shows—contrary to the accompanying text—that most of the spectacular losers in their study eventually turned around and posted spectacular gains. And we've just been through a period in which the entire Nasdaq 100 (the big tech stocks) rose 1,000%, dropped 80%, and then gained back 100%.

Those are wild gyrations, and each stage was marked by unusual levels of greed or fear. The decline of the market from the millennium-bubble peak of four years ago encouraged investors to quit doing their homework and flee; conversely, the huge (largely unwarranted) gains of the last year have rekindled the greed in the hearts of investors—causing many to quit doing their homework and cheer for bigger gains.

It's the homework that counts. When Sir John Templeton counsels investors to "buy at the point of maximum pessimism," he's not suggesting that you buy any stock that investors are fleeing. He's saying that you should do your homework at a time when others are not.

— 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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