

Quarterly Investment Commentary | *January 2005*

Stocks finished the year with a strong fourth quarter, bringing the full-year gain for 2004 to a healthy 10.8% for the S&P 500. Small-caps did even better, gaining slightly more than 18% this year as measured by the Russell 2000 index. Comparing value and growth, value held a big edge, with the Russell 3000 Value index gaining almost 17%, while the Russell 3000 Growth index was up just 7%. REITs had a dominating but volatile year, finishing with a full-year gain of more than 30%.

On the fixed-income side, investment-grade bonds, despite starting the year somewhat overvalued, managed a decent year, with the Lehman Aggregate Bond Index up about 4.3%. High-yield bonds, which have both bond and equity characteristics, had a very stock-like year in 2004 and as such did quite well, with the Merrill Lynch High Yield Master benchmark gaining almost 11%. Even though junk bonds' had low spreads over investment-grade bonds in the beginning of 2004, we tactically overweighted them. Our decision was based on our belief interest rates would rise in 2004 and we felt more comfortable taking on credit risk in the high yield sector than interest rate risk in investment grade bonds. Obviously, this proved to add tremendous value as our fixed income allocation outpaced the Lehman Brother Aggregate Index. Foreign bonds, thanks to sharp declines in the dollar during the final months of the year, had a good year overall, with the Solomon World Government Bond Index gaining 10.4%.

Things Felt Different Two Years Ago

In looking back on a good year, it is worth remembering back to early 2003 when even a decent year for the markets seemed to be wishful thinking. At that time, we were coming off of the most dismal year of the three-year bear market, and sentiment was extremely poor. Stocks continued to decline ahead of the Iraq invasion, the economic recovery had yet to gain traction, fears of deflation were starting to take root, and terrorism risk was on the front of investors' minds. Amidst this backdrop, the emotional reaction was to get defensive. But the rational reaction was to look at valuations and recognize that the market was already pricing in what seemed to be an unreasonably high level of risk. In sticking to our valuation discipline, we maintained our equity exposure and were rewarded, with the S&P 500 gaining almost 52% since it bottomed on March 11, 2003.

Some of the same big-picture risks from that time continue to impact our thinking today and some don't. The threat of terrorism remains in the background, as may always be the case. The uncertainty of an invasion of Iraq is replaced with concerns about the costs and difficulties in trying to establish a working government there. The structural imbalances in the economy are now among our biggest worries. In particular, the potential of a dollar collapse, and the impact it would have on the rest

of the economy, remains a meaningful risk. We say meaningful because, while we don't think the chances of a dollar collapse are high, the impact would be broadly negative across the world economy.

The problem is that we depend on foreign capital to fund our current-account deficit, which is at an all-time high (the current account measures the balance of imports, exports, net investment income, and unilateral gifts between the U.S. and foreign entities). The dollar has declined materially already, and some experts believe a near-term correction where the dollar strengthens is possible. But most experts agree on the likelihood that longer term the dollar will decline further. A declining dollar could mean higher interest rates are required to attract the capital to fund our current account deficit. With many consumers already facing high household debt levels, including a lot of variable-rate debt, higher rates could depress spending as consumers lose disposable income to higher debt payments and try to rebuild their balance sheets. It could also take the wind out of the housing market—reducing another positive influence on consumer spending.

We don't mean to paint a depressing scenario for the new year. What we want to do is remind investors that following a good year, or in this case two good years, it is easy to feel good about the markets and ignore the risks. And following a bad year, or three-plus bad years as was the case in early 2003, it is easy to overplay the risks (even as cheap valuations provided a big cushion). **This inverted perception of risk and reward is what underlies the bulk of the decision errors made by investors.** We view our job as ignoring the psychological impact of recent market performance and focusing on the fundamentals, both negative and positive, and there are plenty of positives or offsetting factors as well. For example, the economy is generally healthy with global economic growth near a 30-year high. Productivity growth has been a positive. The U.S. consumer may not be in as bad shape as many think: credit card delinquencies have declined, and household assets have risen thanks to strong home prices. Corporate earnings have been very strong, and most corporations have plenty of cash on their balance sheets, which bodes well for capital spending. Valuations aren't as good as they were, but are still well within a range we consider fair. So where does that leave us going forward?

Domestic Equities

Given the strong run we've seen from equities over the course of the past two years, it's not surprising that our return expectations have come down. In our base-case five-year scenario, which assumes 3% average inflation and 5% average earnings growth, we look for equity returns in the mid- to upper single digits. However, there are scenarios, such as a dollar crash or a debt crisis that would likely result in much lower returns, especially over shorter time periods. We still believe the base case is the most likely outcome, but there are clearly other environments in which equity returns could be lower. This is part of the reason we continue to own high yield bonds, as we mentioned earlier.

With respect to style, value has been dominant over growth since the bursting of the tech bubble in early 2000. In four out of the past five calendar years, the Russell 1000 Value has massively outperformed the Russell 1000 Growth, after beginning that period with a huge valuation advantage. We have said in the past that it wouldn't surprise us to see value overshoot, and our current analysis tells us that if anything growth stocks might be slightly more attractive at this point. Our discipline requires a clear valuation advantage before making a tactical bet, and this is not the

case right now, but if growth continues to underperform, **it may reach fat-pitch status at some point.**

Smaller-caps also entered the bubble period with a significant valuation advantage, and have been great performers versus large-caps since 1999. However, by many measures smaller-caps are starting to look a bit pricey, though not clearly overvalued. We reduced our small cap exposure by taking some gains at the end of 2004, but we are not ready to abandon small caps.

Fixed Income

Whereas the equity and commodities markets reflect a fairly good economic outlook, the very low real yields offered by investment-grade bonds are consistent with a consensus expectation for a weak economy. Given the low yields, big returns from bonds would require a meaningful drop in interest rates, which is unlikely with the Fed clearly in a slow-and-steady tightening mode. And with a massive budget deficit, bond supply is likely to increase, which should also put some upward pressure on rates. Foreign governments, particularly in Asia, have been huge buyers of Treasuries in recent years, but at some point their willingness to add to their Treasury positions will wane, and the resulting reduction in demand could also lead to higher rates. Because of all this we are still overweighting high yield bonds and have kept a minimal amount of investment grade in portfolios. We hired Power-Hamlet in early 2004 to actively manage our bond portfolios. We are confident in their abilities to manage bond duration, coupons and find pricing anomalies in the fixed income market, which are present and can be exploited. We have a small allocation to investment grade bonds (FPA New Income) because they continue to have an important role to play as volatility reducers in the event of a bear market or as protection in the event that we tip back towards deflation.

Although our philosophy is to consistently hit singles and doubles our ability to think outside the box resulted in a home run for our clients who are invested in the Blueriver Municipal Arbitrage Strategy. Blueriver exploits a fundamental pricing inefficiency that persists across the maturity spectrum in the municipal bond market. The fund uses leverage (9x) to generate a high level of tax free income and at the same time hedges out all the interest rate risk by buying interest rate swaps (shorting interest rates). Credit risk is also mitigated by investing in only AAA rated municipal bonds. In 2004 Blueriver distributed tax-free income of 13.10% (The taxable equivalent to this to an investor in a 35% tax bracket is 20.1%) and had capital appreciation of over 6%. We believe our ability to think outside the box and search for fixed income alternatives in a low interest rate environment added tremendous value to our fixed income returns.

International Equities

As we have been saying for a while, on a statistical basis foreign stocks look cheap, but they have always sold at a discount to U.S. stocks, and undervaluation in the past has not always resulted in outperformance. Because we have less confidence in the data in this area, our threshold for making a tactical bet is higher than it is for domestic equities. We like the diversification our international exposure provides, but it is not currently a fat pitch.

Commodities

In a much lower-return environment with no clear fat-pitch opportunities, we've devoted considerable research to new areas in our search to add value. Commodity-based investments, which have gotten a great deal of attention thanks to their strong performance in recent years, have been on our radar screen for the past two years and we've done research getting our hands around this asset class. We have a small amount of money allocated to the Pimco Commodity Real Return Fund. However, we will not have a large percent allocated to commodities as we expect that many investors will be piling into them with little thought given to the inflation expectations that are already priced into commodities, and what this means for their return outlook over the next few years, or to the fact that in the past there have been periods of strong commodities performance followed by periods of very poor performance.

Alternative Investments

An area we believe we have added tremendous value over the past 5 years is our understanding of the risk/reward characteristics of hedge funds. Only recently have hedge funds become extremely popular with wealthy and institutional investors. Many started chasing the strong relative performance of hedge funds over the traditional indices the past couple years. Our longer term understanding and utilization of hedge funds gives us a tremendous advantage over many of the new investors entering this asset class. Hedge fund performance was down in 2004, but we still believe this asset class adds value and improves the risk/return characteristics of our portfolios. We have said many times we are in this asset class not for the higher returns, but for the reduced risk.

After two years with the COAST FOF we have decided they are too big for us and have identified a capable alternative. For those clients invested in COAST we are liquidating your position as of January 31, 2005 and will be reallocating the funds to the Trust Advisors Leveraged Fund II. This fund has been setup exclusively for Lido clients and offers similar diversification as COAST, but has a more favorable tax treatment. The fund is registered as a warrant not a limited partnership. This means that all gains are taxed as long term capital gains at the end of the warrant (5 years, however, the fund offers weekly liquidity and the funds are not locked up for the term of the warrant.) In a limited partnership structure short term capital gains and interest income are usually high as hedge funds generally do a lot of trading. We have done an extensive amount of due diligence on Trust advisors and are confident in their ability to provide excellent risk adjusted and after tax returns to our clients. We are also eliminating our mutual fund investments in the Merger Arbitrage class in favor of more opportunistic managers. In our opinion there is too much money chasing the returns in merger arbitrage. This causes the arbitrage spreads to contract resulting in lower expected returns. We are reallocating these funds to more opportunistic managers and will rely on their extensive research and discipline to provide solid risk adjusted returns.

With No Fat Pitches, Managers Are Key

Reflecting the lack of compelling opportunities and our big-picture concerns, both of our current tactical plays are based on risk containment rather than pure return

potential. We are underweighted to investment-grade bonds in favor of high yield bonds, as we expect rates to move up over the next several years. We also own FPA New Income (Investment Grade), which currently has a very short duration. Given the lack of return-based fat pitches, our managers are especially important right now as a source of potential outperformance. We feel that over the long-term, the funds we use should be able to beat their benchmarks, but we do not expect that this will be the case every single year.

Similarly, while we have been fortunate to have a generally good year once again with respect to our own performance, we remind our clients that this will not always be the case in the short term. But we are confident that by working hard to make well-reasoned investment decisions and staying disciplined we will be able to continue to generate above-average returns over the long term.

***– LIDO ADVISORS INVESTMENT
TEAM (1/10/2005)***

December Benchmark Returns (Preliminary)		
	Dec	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	3.4%	10.7%
Russell 1000 Growth iShares	3.9%	6.1%
Russell 1000 Value iShares	3.3%	16.3%
Mid-Cap Benchmarks		
Russell Midcap iShares	4.2%	19.9%
Russell Midcap Growth iShares	4.8%	15.2%
Russell Midcap Value iShares	3.8%	23.3%
Small-Cap Benchmarks		
Russell 2000 iShares	2.9%	18.2%
Russell 2000 Growth iShares	3.6%	14.1%
Russell 2000 Value iShares	2.4%	22.0%
Other Benchmarks		
Vanguard Total Intl Stock Index	4.4%	20.8%
Vanguard REIT Index	4.8%	30.7%
Vanguard Total Bond Mkt Index	0.9%	4.2%
Merrill Lynch High-Yield Master	1.5%	10.8%
Salomon Brothers World Govt Bond	1.7%	10.4%