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I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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MID-YEAR UPDATE *Addressing the Conundrums*

The economy is decelerating, and concern has emerged that the recovery may be at risk. However, last year's 4.4% growth was significantly higher than normal (3.2% over the last 20 years). Therefore, a deceleration into the 3.0% - 3.5% range should be viewed more as a return towards the norm than a more ominous precursor.

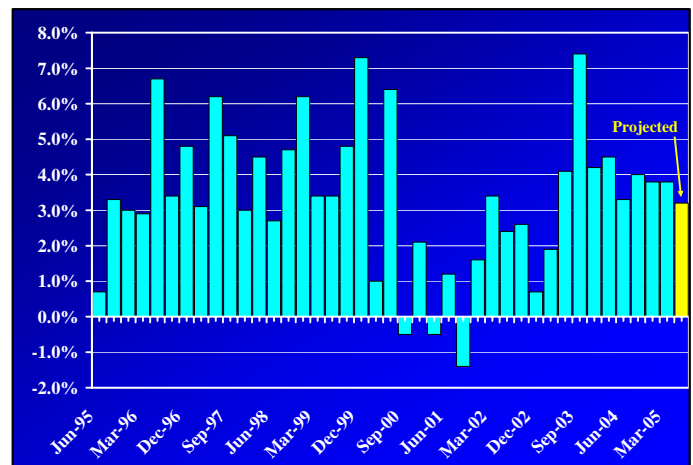
Actually, the expansion has been stronger and more durable than generally expected. Its strength has been associated with a combination of a resilient consumer who defied expectations of a spending slowdown, inflation rates that were minimally impacted by record crude oil prices, and an interest rate structure that seemed to ignore nine successive increases in short-term rates by the Federal Reserve. These conundrums make this economic recovery unique, and one that may not follow the traditional path.

Conundrum #1 – The Consumer. It was expected that the consumer would be at the forefront of an economic slowdown. Contrary to those expectations, and in spite of harsh winter weather in the northeast, consumption growth maintained a 3.5% - 4.0% pace throughout the winter and spring. Undaunted by record crude oil prices and rising short-term interest rates, the consumer benefited from a stronger job market, higher hourly earnings, and further appreciation in the value of their homes. As a result, their confidence in the economy rose, which was reflected in their willingness to increase their spending. As long as mortgage rates remain modest and home values retain their recent appreciation, the consumer could continue to support economic growth.

Conundrum #2 – Inflation. In spite of record crude oil prices, inflation rates have not accelerated to the degree many feared. So far this year, the estimated increase in the consumer price index is about 3%, only marginally higher than last year. The impact of higher crude oil prices has been muted by: (1) the importation of less expensive foreign made goods; (2) better utilization of our factories through rising capacity utilization rates; (3) outsourcing of labor

costs to regions with lower employee wages; and (4) more efficient distribution of goods and services through technology and the internet. These elements should continue to exert a moderating influence on inflationary pressures.

CHART I
Gross Domestic Product (GDP)
1995-2006



Conundrum #3 – Interest Rates. Nine successive short-term interest rates increases by the Federal Reserve in less than a year had little impact on longer-term rates. To the contrary, longer-term rates actually declined. In the last year, the benchmark ten year Treasury yield declined from 4.3% to 3.9% and long-term corporate yields declined from 5.8% to 5.3%.

Several factors offset the Federal Reserve's efforts to exercise monetary restraint through raising short-term interest rates. First, the expanding economy increased corporate profits and cash flow, which in turn, muted business demand for funds. Second, and perhaps more important, countries, which formerly ran large trade deficits and were heavy borrowers in the international markets, have more recently reduced their spending and increased their saving. As a result, international financial liquidity has

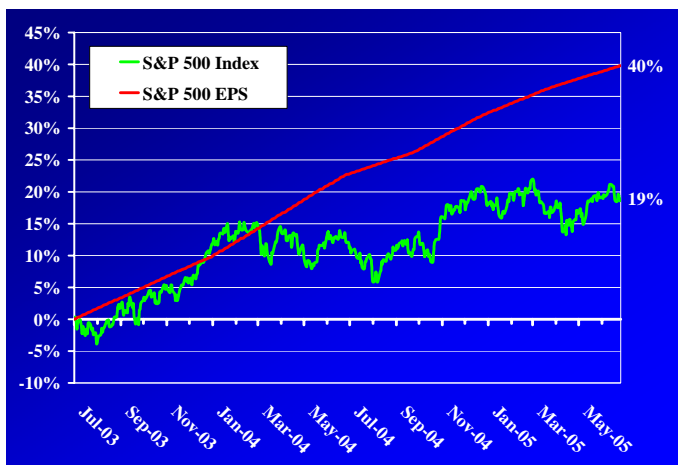
increased and worldwide demand for dollar denominated securities increased.

Global financial trends have, in a sense, neutralized some of the Federal Reserve's effort to tighten monetary policy. This could mean that the Federal Reserve may need further monetary restraint to accomplish its goal of containing inflationary pressures, particularly if crude oil prices continue to rise and/or they view the rise in home values as too speculative.

INVESTMENT STRATEGY

The first half of 2005 can best be described as an up and down six months with few discernable trends. Stock volatility was primarily associated with the rise and fall of crude oil prices and secondarily by fluctuations in interest rates. At mid-year, stocks had negative returns. The Standard & Poor's Index recovered most of its March-April decline while the Dow Average ended the first six months of 2005 in the half of its trading range. On the fixed income side, three month U.S. Treasury yields advanced from 2.2% to 3.1% but the 10-year U.S. Treasury yield declined enough to generate a positive return of 3.7%.

CHART II
Standard & Poor's Index
Price vs. Earnings Growth
June 2003-June 2005



In spite of this first half "wobbling" in the financial markets, the outlook for the balance of the year remains relatively unchanged. An extension of the economic recovery should lead to a further increase in corporate earnings. In 2005, per share earnings for the Standard & Poor's Index is now expected to rise eight percent, after a series of upward revisions over the last six months. A further increase of six percent is expected in 2006.

While the process of upward revisions in earnings has taken place, stock prices remained relatively stagnant. Over the last 2 years, earnings for the Standard & Poor's Index rose 40% while the Index itself advanced only half as much. As a result, the price-earnings ratio (trailing 12 months earnings) declined from 19.3 to 16.8. It is only 16.4 times calendar 2005 earnings and 15.8 times next year's earnings. Stocks now trade at the low end of their value range for the last ten years.

Thus, from a valuation standpoint, the stock market is attractive, and appreciation prospects have improved. For the appreciation to be realized during the second half of the year, however, further evidence regarding the durability of the economic expansion will be required, especially in the face of elevated crude oil prices. This also assumes that the Federal Reserve will be able to gradually increase short-term rates interest rates, the impact of those rate increases will continue to be muted by liquidity in the international financial system, and speculation in the housing market will be tempered without jeopardizing the equity that households have in their home.

On the other hand, the outlook for bonds is less favorable. While global conditions caused intermediate and longer-term interest rates to decline during the first half of the year, it would be naive to assume that those securities will continue to be immune from further monetary restraint. As the economic recovery gains maturity, particularly with the expansion in the industrial sector of our economy, domestic demand for funds should eventually strengthen and corporate liquidity contract. At that time, the increase in short-term yields will permeate into the longer maturity securities. Therefore, longer-term bonds will have difficulty doing as well during the second half of the year as they did the first.

TABLE I
MARKET PERFORMANCE COMPARISON

(Including Interest and Dividend Income)
*Year to Date**

MARKET INDEX	12/31/04	06/30/05	Return
Standard & Poor's 500	1,212	1,191	-0.8%
Dow Jones Average	10,783	10,275	-3.7%
NASDAQ	2,175	2,057	-5.5%
EAFE Index	1,515	1,474	-2.7%
3 Mth U.S. Treasury Bill	2.2%	3.1%	1.2%
10-Yr U.S. Treasury Bond	4.2%	3.9%	4.6%
10-Yr AAA. Tax-Exempt	3.6%	3.5%	2.6%

*Estimate