Trusted Advisor

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By Gary E. Miller, C.F.P.

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Contact Gary Miller at 949-249-2057
E-mail: Gary@trustedfinancial.net

Three Year Performance Report

An understanding I have with each new client is to defer judgment of portfolio performance long enough to see how we do in both good and bad markets, in other words, a full market cycle. This generally requires "three to five years", a phrase that should be familiar to all who've engaged my services.

While many clients have worked with me now for over fifteen years, it has been only a bit over three years in which I've exercised discretion. I am therefore completely answerable for the past three year's performance, a period that has witnessed both a devastating bear market for stocks around the globe and an impressive recovery as well.

Now that pretty much a full market cycle has occurred, it is pleasing to report our results over the period March 31 2001 through March 31 2004, and to compare our work with that of other commonly cited investment performance measures.

Annual Average Returns, March 31 2001 - March 31 2004[1]

Index	Return
Trusted Financial Advisors Composite	+6.28%
Average of 443 Balanced Mutual Funds	+2.93%
Standard & Poors 500 Total Return	+ .63%
Dow Jones Industrial Average	+3.74%
Taxable Bonds (Lehman Brothers Aggregate)	+7.44%
Tax Free Bonds (Lehman Brothers)	+6.49%
International Stocks (Morgan Stanley Composite Index EAFE)	+1.39%
Note: All are total returns. Source: Wall St, Journal April 5 2004	

The most relevant comparison figure is the Balanced Mutual Fund average. But unlike mutual funds, which offer a "one size fits all" portfolio, our clients receive personalized attention. A retiree who is taking annual Minimum Required Distributions from her IRA may have a significantly different blend than a 45 year old executive who is hoping to be able to retire in ten years. Most balanced mutual funds confine their activities to three asset classes: U.S. stocks, U.S. bonds and cash. As clients know we spread the risk among many asset classes, and geographically as well. Our broadly diversified approach is supported by the work of Roger Gibson[2] and Robert Arnott[3] who have both argued that U.S. residents benefit by inclusion of asset classes that do not follow or "correlate" to the U.S. stock market. In the most recent quarter, for instance, while stocks gave back all of their gains from January, a commodities oriented mutual fund we purchased in December leapt by nearly 17% in value.

Our portfolios allow clients to sleep well at night and seek to achieve a long term annual rate of return between 8% and 10%, depending on the personal needs and risk tolerance of each client. By this measure we have so far failed, but have also significantly out performed mutual funds with a similar, balanced portfolio approach. Considering that two of the past three years have seen one of the worst bear stock markets on record, I feel that with more time

we will close in on our target performance. At any rate, clients have been generous with their praise, which is gratefully acknowledged.

What accounts for our superior balanced performance in terms of return? Well, as mentioned, we have employed investments that were not considered mainstream in the days of the "High Tech" frenzy. Things like international bonds, real estate investment trusts, energy partnerships and the aforementioned commodities. Likely the best choice we made for our clients was to heavily emphasize a diversified portfolio of bonds from early 2001 through mid 2003. We significantly reduced exposure to bonds for most clients after U.S. interest rates reached a bottom in Summer of 2003. But exposure to bonds did not mean we were turning our back on income producing investments. As substitutes, we were able to shift emphasis to the above mentioned REITS, MLP's and preferred stocks most of which sported dividends above 6%.

Facing Reality – and Raising Cash

At this time, the challenges facing investors are probably as great as they have been in the past three years. The U.S. stock market remains directionless, fighting to remain above Dow 10,000 in the face of a possible change in the White House, a costly war and burgeoning budget and trade deficits. Value managers like myself, are finding slim pickings to satisfy the search for bargain priced stocks of quality companies here in the United States. Worst of all, some big winners of the recent past appear to have reached over valued territory: I speak specifically of Real Estate Investment Trusts. As yields fall below 5% for many of the better offerings, experts are pointing to a phenomena not seen since about 1996: the "Net Asset Value" or estimated underlying liquidation value of properties, is below the price of most REIT shares. Discounted cash flow analysis, another approach to REIT valuation gives a similar message: REITS are not cheap. For this reason we bid a wistful farewell to some of our clients' REIT holdings in early April. To be sure, this asset class remains part of most client accounts, but to a reduced degree.

Likewise, another core holding, Clipper Fund was reduced for certain accounts. As I observed in my memo to clients for whom we sold some shares:

*"Reviewing the intrinsic value of Clipper's top ten holdings, I was concerned to realize that many of them are stocks **I** would not have purchased using what has been a relatively successful selection criteria. Moreover, Clipper seems to have gravitated toward turn around situations, a potentially risky strategy. It now holds many companies whose management has been replaced because of bad behavior, but which appear to have sound businesses: Fannie Mae, Freddie, Mac, Tyco, Tenet Health Care, El Paso. I still have faith in Clipper's analysts ability to select good companies, but many of these holdings may be dogged by negative publicity for an unpredictable period of time, and the above names represent 30% of the portfolio."*

So client cash positions have grown significantly since the beginning of 2004. We are keeping this powder dry, looking for the few extraordinary bargains that may occasionally come along.

Such an opportunity presented itself in early March, when I found myself scooping up shares of fallen angel, ITT Educational Service (ESI) Giving no reason, and stating no accusation, "Federal Agents"(Postal Service inspectors and local county sheriffs)arrived February 25 at the company's headquarters and ten of it's seventy seven campuses with search warrants. But the government refuses to say what they are investigating. Panic selling ensued. I took a hard look at the situation since we already own Corinthian Colleges, a competitor. The for-profit education industry has a bright future. There is a constant demand for skill and knowledge improvement in today's competitive employment market. Stocks in the industry have generated impressive earnings growth, and share prices rocketed during 2003. I'd snapped up the shares of Corinthian a couple of months earlier after a strange set of events briefly dropped them to a bargain price. Was this a similar opportunity? I dropped everything and ran a series of analyses, most important of which was a discounted cash flow review. It suggested, even with allowance for the costs of legal action, that the stock had become attractively priced. A similar measure, enterprise value-to-free cash flow gave a ratio of 12. When a company is growing its revenues at 20% annually, yet has an EV/FCF ratio of nearly half that, it might be an undiscovered treasure. Finally, I observed the tape action. Yes, this is a technician's tool, and I'm a declared "Value" investor. But there's nothing wrong with applying 30 years of tape watching to fine tune an entry point. What I noticed on March 12 was that with heavy volume, the stock seemed to be finding support above $28.00 per share.

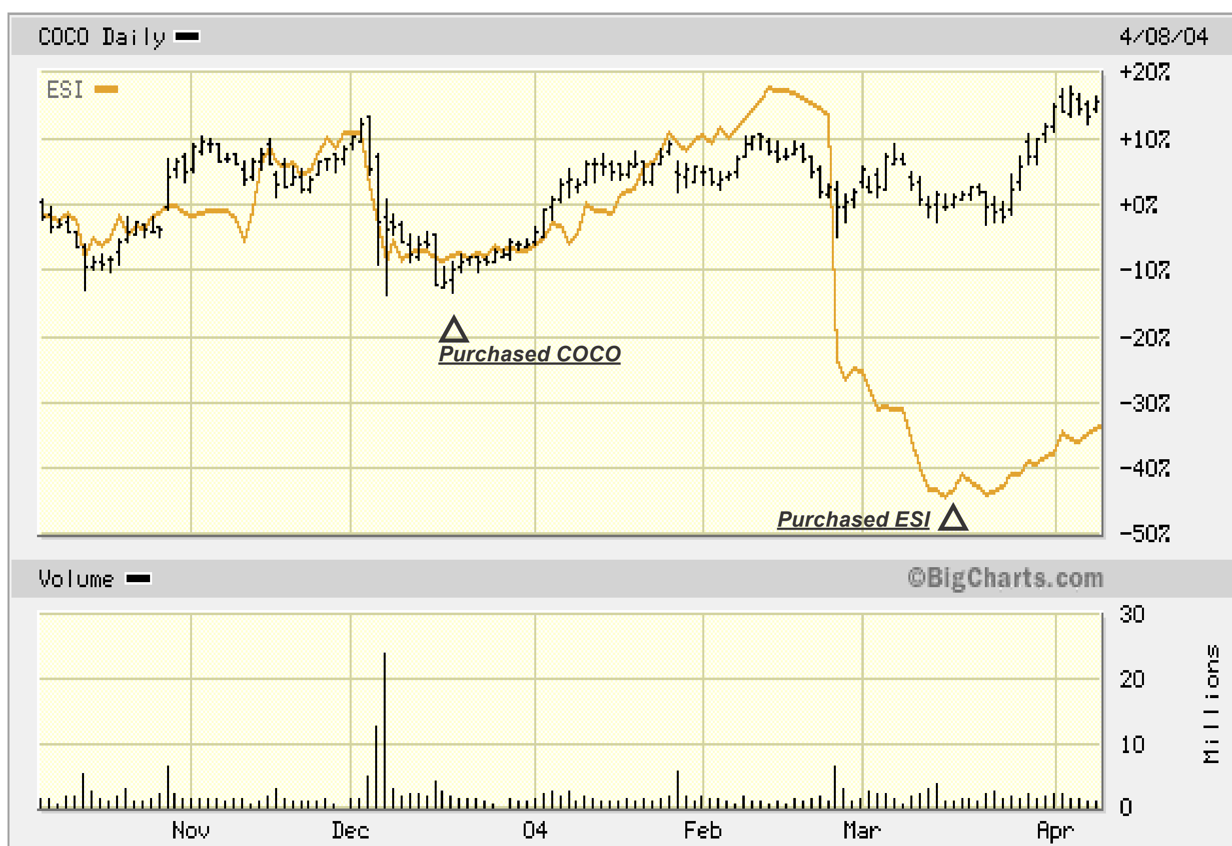
So for accounts who have identified themselves

as being somewhat more aggressive, I made a cautious purchase. As of this writing, no charges have been filed against ESI, and the share price has risen about 15% above my clients' purchase price. But frankly, this situation could change for the worse if some terrible news emerges from the government's fishing expedition. There have been rumblings about the for- profit education industry over the past few months, and other firms have been sued by disgruntled former employees and charged with selling degrees rather than providing a genuine education. Quite possibly the Grand Jury that initiated the investigation of ITT Educational Services is part of a broad government sponsored investigation that could lead to some really bad publicity for the sector. To date, no law suits have been lost by the industry and no government action taken against a single company. Below is a price graph of the two companies.

Retirement Planning Advice

Are you thinking about creating or funding a retirement plan for yourself or your business? Consider having a Retirement Plan Analysis and Recommendation prepared by Trusted Financial Advisors! It is important to get more than one opinion in making important retirement savings decisions. Recently two of my investment advisory clients were given poor advice by their tax accountants with regard to retirement savings. In one case, the owner of a small business unnecessarily contributed more to his employees' pension plan than desired because he was not informed of a credit to which he was entitled for the matching employer contribution to Social Security. In the second situation, a client was led to believe he and his one employee could make "elective deferrals" to a SEP (Simplified Employee Pension) plan. This feature was removed from SEP's in 1997. Without this feature, the entire plan became unattractive to him, after it was established.

The lesson here: do not assume a tax preparer has the answers you need when it comes to retirement planning. Trusted Financial can review your situation and possibly provide another perspective that could open the door to improved tax saving.



(Footnotes)

1 Discretionery client accounts, weighted by size, including reinvested dividends. Time Weighted to adjust for cash inflows and outflows. These figures are not independently audited.

2 Roger Gibson, CFA and CFP is President of Pittsburgh-based Gibson Capital Management, author of Asset Allocation: Balancing Financial Risk, which is widely acknowledged among planners as the leading text on the subject.

3 Mr. Arnott serves as Editor of the Financial Analysts Journal. He has authored over sixty articles for journals such as the Financial Analysts Journal, the Journal of Portfolio Management and the Harvard Business Review.

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