Trusted Advisor

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Third Quarter Review

Despite a deluge of bad news, the third quarter proved to be a positive one for U.S. Equity investors. Widely followed indexes showed the following performance:

• Standard & Poors 500:	+3.60%
• Lehman Aggregate Bond index:	-.67%
• MSCI Europe Australia and Far East Index:	+10.92

Our client accounts, which include U.S. stocks, international equities, real estate securities, commodities and bonds did well too. **The Trusted Financial Advisors composite average (size weighted) rose 4.00%.**

Individual shareholdings First American Financial (FAF) and Teva Pharmaceuticals (TEVA) led the bullish charge during the Summer, a surprise, considering all the hoopla about energy prices. We do have a healthy orientation toward energy, but primarily have taken a conservative approach, focusing on storage and transport rather than the riskier sectors like refining, exploration and production. Exxon Mobil, which dominates in all three activities represents about 3-4% of client holdings, and experienced a solid but not awe inspiring 5% rise last quarter.

The big surprise of the quarter was gold. We have a small position in the metal through ownership of a gold mutual fund, which was up 16%. Despite poor performance for over a year, we stayed with this position not because we share the quasi-religious faith of "Gold Bugs", but because part of our mission is to keep portfolio volatility low. As an asset that has a negative correlation to equities, gold and other commodities, infamous for their stand alone volatility, can actually reduce volatility when incorporated into a broader portfolio.

Most of our other mutual fund selections provided great support for client portfolios during the quarter as well. However, individual stock purchases were a mixed bag. A number of purchases for income oriented portfolios suffered as a result of the growing belief on Wall Street that interest rates are headed high, a belief bolstered by continued increases in short term interest rates by the Federal Reserve. I was beguiled into taking a position in Microsoft, due to improvement of key measures of profitability and the promise of a new round of software introductions, particularly in the vibrant gaming sector. Also, a number of commentators suggested that a meaningful dividend increase was in the offing, something we believe would improve the stock's attractiveness to investors.

Then reports surfaced suggesting the company might invest a lot of cash to buy an interest in AOL as a means of gaining traffic for its search engine, which has been all but forgotten by web surfers. I took this as a sign that MSFT is desperate to catch up to Google. My judgment is that a better strategy for Microsoft is to accept it's place as a software monopoly, and like a utility, pay a much larger dividend. Were the company to do so, I believe

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they would attract a new investor base (having been deserted by growth investors) and find renewed strength in their stock. The AOL acquisition rumors confirmed my lingering fear that management will continue making poor use of shareholder equity, so we exited with a small, but to me annoying, loss. The stock subsequently declined further.

Inflation - Public Enemy # 1 Again on the Loose

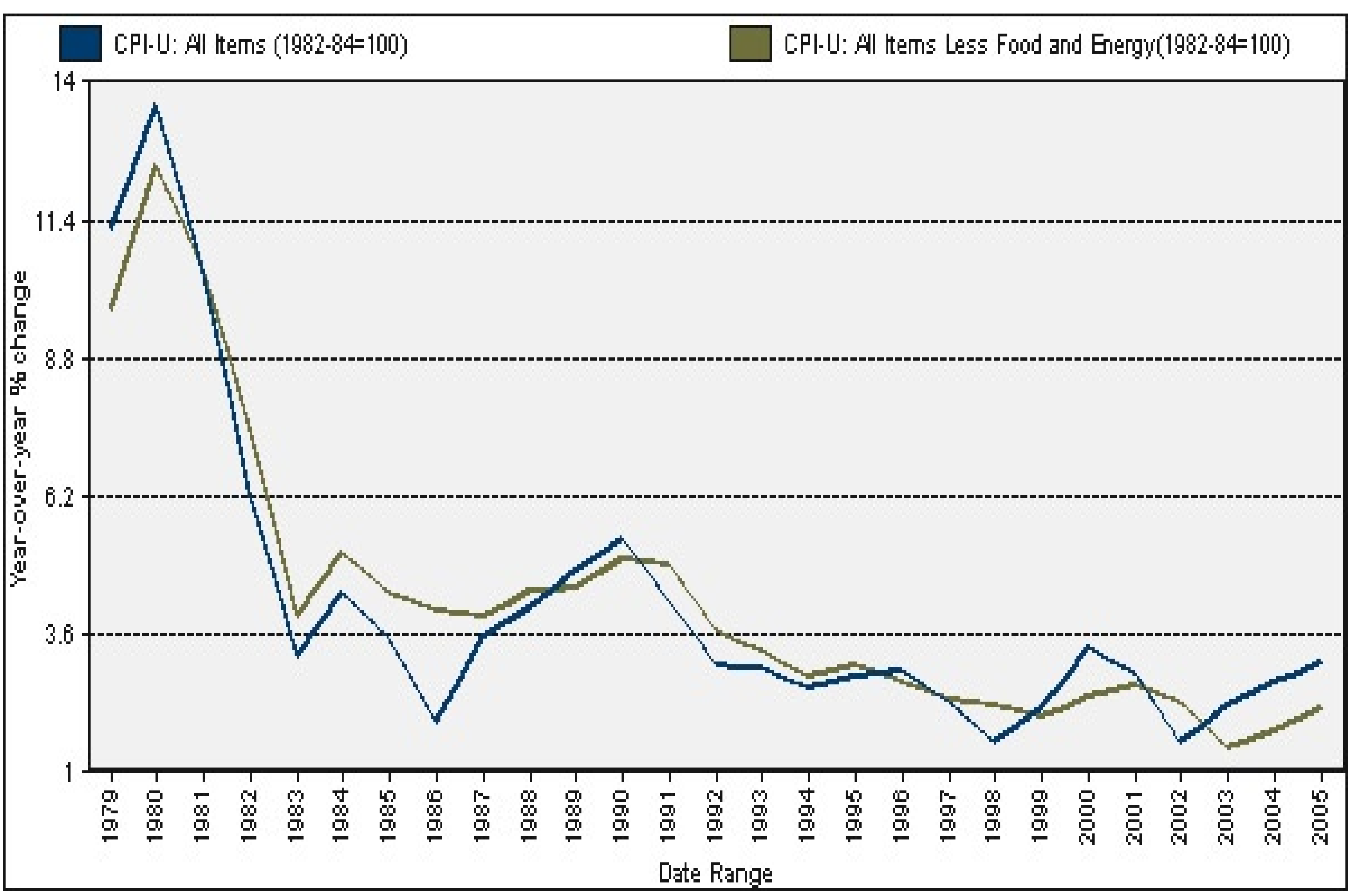
Those of us old enough to remember the 1970's, have learned to fear inflation. Like a silent thief, it destroys buying power. $1,000,000 in 1975 would buy 18 homes in Mission Viejo. Today it will buy one home with possibly enough left over for a condo in the desert (an older condo). Recently my wife and I received a post card advertisement from a local restaurant, Harpoon Henry's, announcing the celebration of 30 years in business. To reward loyal customers, the restaurant is rolling prices back to 1975 levels for a week. The comparisons are striking:

Entree	1975 Price	2005 Price
Top Sirloin	**$7.95**	**$20.95**
Fresh Salmon	**$5.95**	**$16.95**
Calamari Steak	**$4.95**	**$14.95**
Hula Chicken	**$4.95**	**$15.95**

Source: Postcard mailing received October 12 2005

Government economists like to focus on "core" inflation, ignoring actual inflation which includes two essentials, food and energy. While a long term view of both actual inflation and "core" inflation shows that the two tend to converge over time, divergence between the figures can be a precursor of rising and more persistent core inflation. For well over a year now, CPI[1] has risen more rapidly than core CPI, largely due to energy costs. This is the third period in thirty years during which actual inflation is significantly greater than the statistically adjusted "core" measure. All three divergent periods, 1979-80, 1999-2000 and the present owe the positive divergence to a sudden spurt in energy prices. The current period is about to become the longest period in which actual inflation is greater than core inflation since the energy crisis of the late '70's, an ominous development. Can we expect inflation to again fall to the relatively benign levels of the 1990's? Let's look at what led to low inflation:

When Paul Volcker took the reigns as Federal Reserve chairman in 1979, inflation was running well over 10% per year. Volcker's Fed engineered a significant economic slowdown by allowing the market to determine interest rates, rather than by artificially trying to keep interest rates low. This led to a brief period of historically high interest rates, a time of 14% mortgages. The recession that resulted brought down demand for commodities, including energy, and inflation moderated. Under President Reagan, significant tax incentives



encouraged U.S businesses to become more efficient and productive. Deregulation, begun under President Carter[2] continued, leading to reduced costs in key sectors such as trucking, air transport and telecommunications. President Reagan's firing of 12,000 Air Traffic Controllers after they struck in defiance of Federal law in 1981 set the tone for reduced labor union power and declining wage push inflation[3]. These factors contributed to a significant moderation of inflation in the '80's. In the '90's, Bill Clinton, under pressure from Congressional Republicans, presided over the first Federal budget surplus in two generations, which served to strengthen the U.S dollar, reduce imported inflation, and keep business borrowing costs low (the Feds were no longer competing with business for loans). These lower borrowing costs in turn helped businesses to invest in technology (computers and silicon based capital investment) to become ever more efficient. Today, most businesses, due to improved information and manufacturing technology can produce more with far less overhead cost than fifteen years ago. More efficient businesses can hold the line on prices. Finally, "Globalization" has allowed manufacturers to move production to countries where labor is dirt cheap (China, India, Malaysia), then sell those goods at low prices here.

As the chart above demonstrates, all these factors came together to drive inflation down in the 1980's and into the '90's. Still, you may be as shocked as I was to realize how expensive things have become during this period of supposedly low inflation. Consider the price changes at Harpoon Henry's. Since 1980, the cost of living on average has tripled.

More worrisome, we may well be in the early stages of a significant reawakening of the inflation dragon. Many of the benign factors that operated during the past 25 years can no longer be counted upon: the government is again borrowing vast sums to pay for war, disaster relief , homeland security, and soon, a new Medicare drug benefit threatens to add $1Trillion to the national debt[4].

The outlook for a moderation of energy prices is not good: burgeoning demand from emerging Asian nations collides with flattening world production. The initial gains that came from deregulation and technology may not be repeatable. Still, within our borders, productivity remains high, and capacity utilization in the U.S. is well below inflationary levels.

My conclusion: the recent period of low inflation is over, but we are not about to return to the double digit inflation of the 1970's. Because inflation is such a subtle thief, however, investors including ourselves, must remain always aware of this threat to wealth. However, even a gloomy inflation scenario may offer investment opportunities. Our clients have already benefited from inflation in medical, real estate and energy prices. We hope to continue to make lemonade from lemons!

(Footnotes)

[1] Consumer Price Index for Urban residents as reported by the Bureau of Labor Statistics

[2] Airline deregulation took effect in 1977. It was the Carter Administration that also pushed the antitrust suit against AT&T, a move that ultimately led to the breakup of the telecommunications giant and the advent of new technologies and cheap long distance.

[3] At the start of Reagan's term approximately 24% of American workers were unionized, by 2004 this figure was about 13% (Baltimore Sun.com June 8 2004)

[4] Washington Post online February 9 2005: "Medicare Drug Benefit May Cost $1.2 Trillion"