Trusted Advisor

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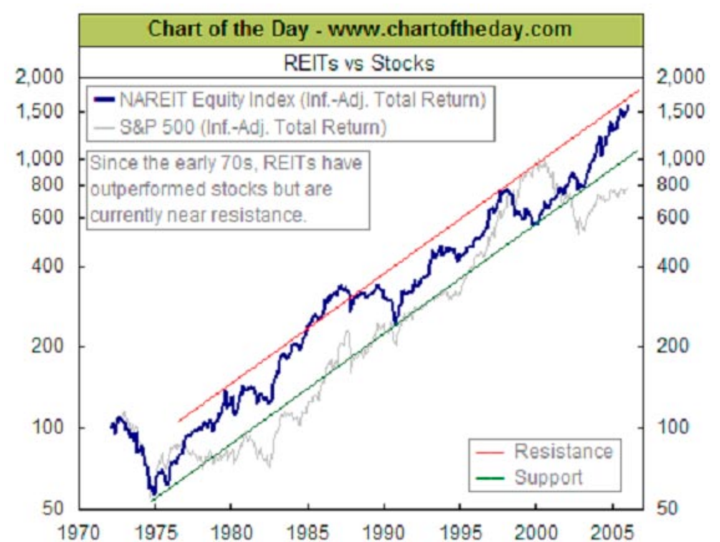
Quarter End Summary

It has been a good quarter. Most asset classes performed well, including U.S. equities, foreign equities, real estate investment trusts and precious metals. Two sectors lagged, however: bonds saw price declines as interest rates rose sharply. Energy related issues gave back some of last year's strong gains too, in part because this was a warm winter with reduced demand for natural gas. We remain strong believers in a secular imbalance between energy needs and available supplies, so are standing firm with our high quality energy related holdings. Despite weakness in these two sectors, client accounts enjoyed positive results. This was one of the best quarters in three years, with many clients again beating the widely followed Standard & Poors 500 index.

That being said, it bears repeating that we do not attempt to beat any particular index. Each client has unique needs, and it is our job to satisfy their needs. Our clients delegate day to day account management to us because our philosophy is simpatico with theirs. In general we try to invest so as to capture most of the upside of the US stock market (which has a long term annual total return of about 10%), but with much less downside risk. In the five years since this writer began managing client funds on a fee-only basis, we have exceeded this objective for nearly all clients. I look forward to discussing this long term track record in detail in the next issue of *Trusted Advisor.*

Time to Exit REIT's?

With interest rates pushing to levels unseen in three years, and after six years running ahead of every major stock index, Real Estate



Investment Trusts may be in for a breather. Our clients saw REITs appear in their portfolios in late 2000 and early 2001, which as the accompanying graph suggests, was a good time to buy. For those who believe in the usefulness of charts, the "channel" line in red, running approximately along previous cyclical tops for this group, suggests we may be at or near another such top for REIT's. In the first week of April, we reduced our position in Prologis for accounts that I felt were a bit heavily exposed, especially as the share price fell below its 50 day moving average on the back of rising interest rates. This star performer, which focuses on global logistics and warehousing has produced total

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returns nearing 100% in the three years it has been held in client accounts. Despite worrisome technical signs for REITS and real estate as an asset class (housing prices are softening), we actually established new positions for select clients in one REIT that pays an unusually high dividend, has recently increased earnings momentum, and which focuses on retirement and supported living facilities. We may indeed be in for sagging REIT share prices in general, but this particular entity and a few others sport a healthy cash flow, with sustainable dividends north of 7%.

How We Plan to Deal with Rising Interest Rates

The topic of REIT's brings me to our prospective approach to the rising interest rate environment that has already hurt bond prices and threatens to bite into equity returns. For 2-1/2 years now, the Federal Reserve has been regularly raising short term interest rates, the ones they control, in an effort to head off an inflationary spiral that traditionally results from a too healthy economy. I began to worry about the potential effect of this steady increase on bond prices in Autumn 2004, when we significantly reduced client exposure to bonds. Still, with foreign investors pouring money into intermediate and longer maturity US Treasuries and other bonds, overall interest rates remained low far longer than we and many economists expected. With low rates, the housing boom extended its six year run into seven and fueled consumer spending; home owners used their homes as a credit card substitute. In the past three months, longer rates have risen rapidly, with predictable effect: residential real estate prices are falling, car sales have fallen and bond prices are being hammered. So far, US equity prices in general have defied this trend, but those of us who've lived through these cycles before strongly suspect the clock is ticking for this bull market.

To prepare for a rising rate environment, we began shifting emphasis toward bond substitutes even before Fed policy turned. High dividend paying equities, REIT 's and utilities that I view as likely to produce reliable, regular payouts, and, equally important, that are likely to raise these dividends. As dividend payouts are increased, such financial instruments can remain attractive even in a rising yield environment, and are, in my opinion, less likely to lose their investor constituency to high yielding alternatives like Certificates of Deposit or quality bonds.

Make no mistake – at some point interest rates will rise to a level where money begins shifting from US equities to fixed income instruments. Our strategy for this event (AKA "Bear Market") is to :

1. Own the highest quality stocks , the kind you do not mind holding, even in a weak market.
2. Devote a substantial portion to non-US based companies in parts of the world that may be growing at a better clip than the US, or where better bargains are to be found.
3. Diversify the portfolio into non traditional investments such as precious metals, foreign bonds, foreign real estate. These are sectors which do not follow the trend of US stocks (low corellation).
4. Devote more portfolio assets to money market funds, which have no risk of loss.

Our client portfolios produce higher current yields than the average equity holding, but for most clients, this is a growth and income portfolio. Behind the dividends there must be sufficient free cash flow to not only support each quarterly distribution to shareholders, but to assure the underlying business has an adequate source of capital for modernization, expansion and perhaps, share buy backs. Further, we try to ascertain that management uses this free cash flow rationally. Evidence can be found by following the "Shareholder

Equity" row in the company's Balance Sheet. A steady increase, commensurate with other growth metrics is a good signal.

United Parcel Service Shareholders' Equity							
YEAR	1999	2000	2001	2002	2003	2004	2005
($BB)	$12,474	$9735	$10,248	$12,455	$14,852	$16,384	$16,884

An example would be a familiar company, United Parcel Service (UPS). Since the year 2000, when equity slipped, the company has grown shareholder equity at a compounded annual rate of 11.59%, while paying a dividend.

While UPS will likely experience lost volume if the economy slows, the above record suggests that it has a high likelihood of surviving any recession that may be ahead, and resuming its long term growth.

There are many more screens we uses to choose investments, but this will give you a flavor of our thinking and how we provide a "Seat belt" for each client's journey along life's financial highway!

How Much does it Cost to do Business with Trusted Financial?

I am often guilty of assuming that a new prospective client understands the cost of doing business with us. There are only two costs to consider: the cost for money management (our fee) and the cost for brokerage. As with most Registered Investment Advisors, we charge a fee, paid at the beginning of each quarter for handling investment decision making and executing buys and sells while timing the trades to optimize performance. The brokerage firm that holds your securities and funds, usually Charles Schwab & Co is not affiliated with Trusted Financial. They are a so called "Broker-Dealer" and they receive a modest fee for trade execution only. This cost has averaged less than .25% of client account values per year during the five years we have worked with Schwab.

Trusted Financial's fee structure is as follows:

First $500,000 _____________ 1.25%
$500,000 to $1,000,000 ______ .75%
$1,000,000 to $4,000,000 ____ .50%
Above $4,000,000 _______negotiable

We invite prospective clients to compare our fees (combined with those of Schwab) with others. We provide service and sucessful account management at a cost that is very competitive.

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