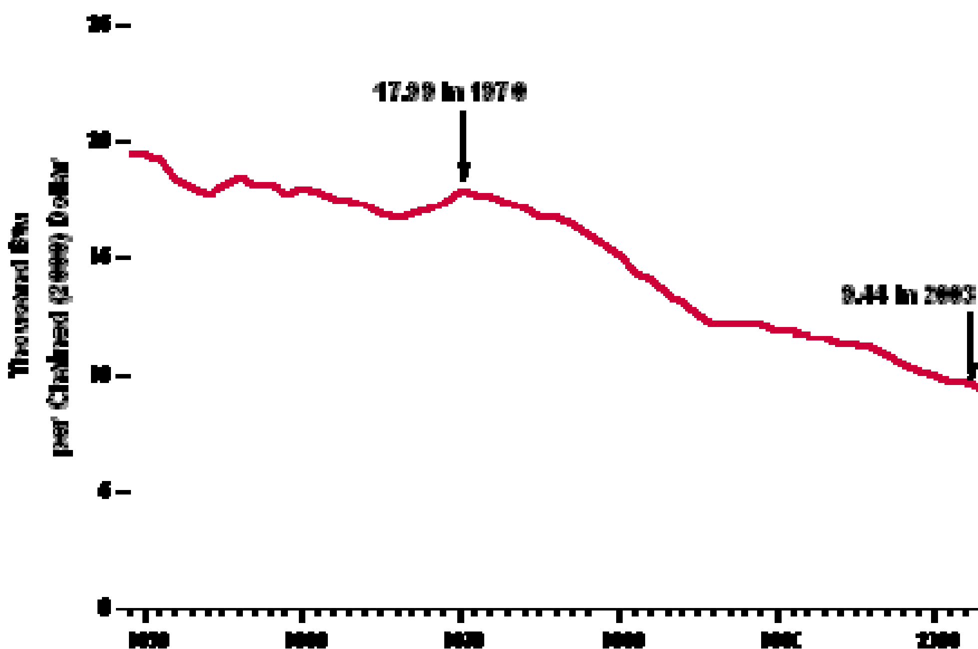
SECOND QUARTER 2005

The concern over energy prices has come up in several client meetings recently. There is a mild paranoia that rising energy prices are a major threat to economic growth and stability. The theory is that energy prices will slow the economy by (a) sapping consumers' buying power, leaving less money for discretionary spending, and (b) dramatically increasing inflationary pressures throughout the economy by adding to the cost of practically everything. There are also opinions that world production has peaked and will go into decline, combined with burgeoning Chinese demand, only exacerbating the situation. We're not too worried despite the pain at the gas pump (or more precisely, when the gas card bill arrives). As we usually do, it's useful to begin analysis be examining the lessons of history.

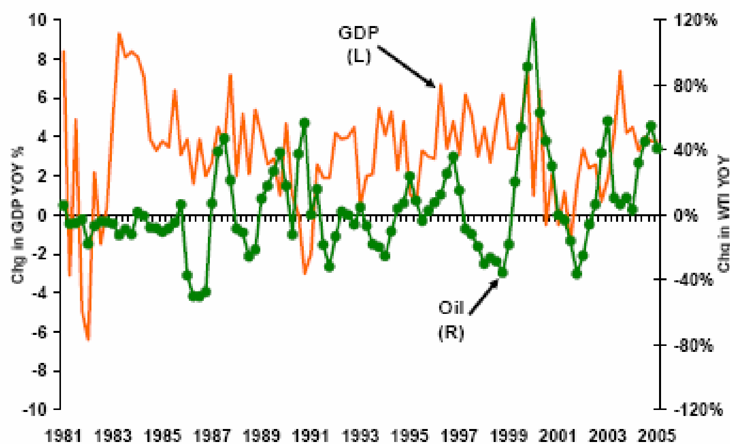
What, me worry about energy?

When one thinks of an "energy crisis", those of us old enough remember the 1973-1974 OPEC oil embargo. Those were the unsettling days of no gas sales on Sundays, buying gas on days determined by your license plate number, and a national 55 miles per hour speed limit. Gas prices doubled, then tripled. No doubt, those memories affect our thinking today and make us contemplate a modern day replay.

An objective examination of then versus now will show that there are significant differences. OPEC is not the solid bloc that it once was. While the situation could always change, the US has enough friends (or at least non-enemies) in the petroleum producing world that a complete cessation of oil imports looks like a very remote possibility. Granted, a higher percentage of oil imports come from the Middle East now versus 1973, meaning that efforts to stabilize that region are all the more important. Nevertheless, in one sense, our economy is now less energy dependent now than in the past. The amount of energy required to produce $1 of GDP is now about half the amount 35 years ago. While energy is obviously important to the economy, the economy can do more with less energy than in the past.

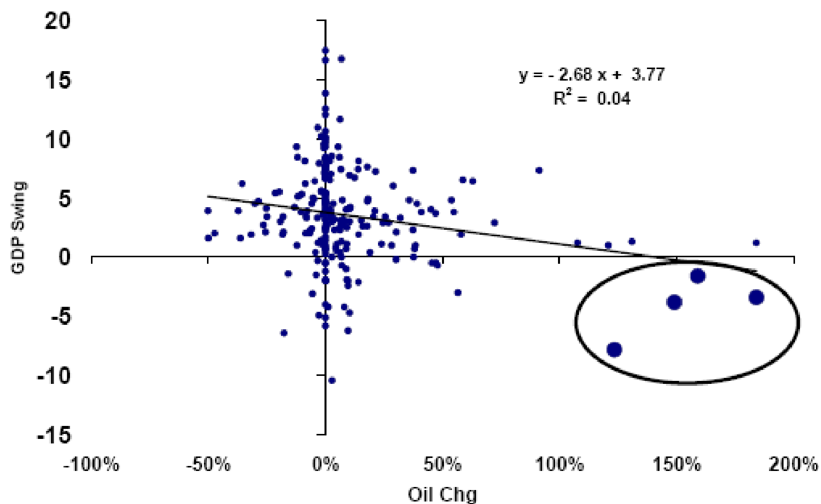


Still, many are understandably troubled by the quantity of oil imports or the percentage of oil consumption that is imported. These are, without doubt, important strategic issues facing our country. There are many opinions on solutions, such as alternative fuels, opening up the Arctic National Wildlife Refuge to drilling, or raising automotive fuel mileage standards. It seems to us that there is no single, good solution. Even the sum total of conservation and more production seem unlikely to keep us from a future supply/demand imbalance. Ultimately, we believe that the market forces we learned about in Principles of Economics will come into play (as they always do) and provide the ultimate solution, however painful it may be. As energy prices rise, supplies will likely increase, thereby putting an effective limit on how far the price can rise. Many potential sources of energy (biomass, tar sands, shale oil, imported LNG) are simply too expensive to be economical at today's energy price levels. However, if prices rise, these and other technologies become financially feasible to utilize. While higher energy prices will probably become a permanent reality, an economy devastated by critical energy shortages is probably not in the cards.



But gearing up new technologies takes time. In the interim, won't the economy suffer greatly due to rising prices? The answer, based on experience, seems to be "no." If you plot out economic growth versus changes in oil prices since 1981, you don't derive a noticeable pattern between the two. In fact, the statistics indicate a slight *negative* correlation.

If we take an even longer term view, analyzing data since 1947, the picture is the same. There is not a statistically verifiable correlation between rising oil prices and an economic slowdown. The period that is always pointed to as the example of oil prices and economic growth being joined at the hip are the last half of 1973 and the first half of 1974, when oil prices rose dramatically and (seemingly) throwing the economy into recession. Those four quarters are circled in the adjacent chart. It is readily apparent that those periods are statistical outliers and do not represent normal events. Most economists agree that the economy was already headed for recession in 1973 and the oil price shock only deepened it.



Of course, it's good if you own the thing that is going up in price, Portfolios with direct energy exposure have received a small performance boost this year. (We have always believed an allocation to energy to be prudent diversification. But now is *not* the time to go load up heavily on energy funds.) The second quarter saw a variety of returns among the major asset classes. The S&P 500 gained a modest 1.4%, while the smaller-cap Russell 2000 chalked up a solid 4.3% gain. Bonds rallied, with the Lehman

Aggregate index moving up 3%. The equity managers in our portfolios—as a group—held their own during the second quarter, but the shorter duration of our fixed-income allocations, along with our foreign bond positions in some portfolios (which was essentially flat), caused the sector to underperform the benchmark. So far, 2005 is shaping up to be at least a decent year for your portfolio.

Many clients have exposure to the commodities futures asset class through PIMCO Commodities Real Return Fund, MLM Index Fund, or the Aspen Diversified Fund. Due to different strategies employed, the MLM Index Fund has struggled this year while the PIMCO fund has experienced a nice gain. We believe the long-term case for the commodities asset class remains valid.

In the near future, you will be receiving an updated investment advisory agreement. This updated agreement is to revise provisions related to discretionary rebalancing and proxy voting for your accounts. To improve the efficiency of the portfolio review process, we are separating that function from regularly scheduled client meetings. This will allow us to rebalance portfolios and make adjustments on a more timely basis. On occasion, portfolio reviews have been excessively delayed due to client scheduling problems. Routine rebalancing or fund replacements within the parameters of your investment policy statement will no longer require your approval. Of course, any major changes to your investment allocation or strategy will be discussed and approved by you in advance.

Another change is in our proxy voting procedures. For many years, we felt a moral obligation to vote proxies to represent your interests in the corporate governance process. However, as the firm has grown, the burden of voting proxies has grown substantially. As you know, some proxy documents can be over a hundred pages long, requiring much reading time. Eventually, we questioned whether this was a good use of our time and taking away from the more important functions of investment research, portfolio management, and client service. While we felt voting proxies was a commendable activity, we had to honestly ask ourselves if it added any real value to you. Let's face it, will our voting a few hundred or even a few thousand shares ever make a difference? I can't ever recall a Board of Directors candidate who was not elected or an auditor who was not confirmed. While reading shareholder proposals from the International Brotherhood of Boilermakers and Lace Workers or the Holy Immaculate Order of the Sisters of Divine Mercy made for some interesting reading, we doubt if our vote ever mattered. While we believe everyone should participate in the political process and vote at the polls, that process does not require hours of your time each and every week. Of course, you are welcome to receive and vote your proxies if you desire. Just let Cindy Carroll know.

The new voice you hear on the phone at Matrix belongs to Chenetta Williams, our new administrative assistant. Chenetta is a native of Raleigh and was previously employed with Aon Consuting, working with defined benefit retirement plans. She attended Winston Salem State University and is currently studying for a business degree through Montreat College. She has an eleven-year-old daughter. We are delighted to have Chenetta join our team!

Investment Markets Outlook

Since some readers will find this analysis mind numbing and quite boring, we have segregated it into a separate section. So read on at your own risk! Going forward, our most-probable-case expectation is that equity returns will average in the high single-digits, whereas bond returns—due in large part to their extremely low absolute yields—are going to have a hard time gaining beyond the low single digits, although they still provide important diversification in the event of a large equity market decline. (Of course, there are a range of possible outcomes, and these numbers are our best guess of the outcome we think is most likely.) Among the equity asset classes, we view small-caps as being slightly pricey relative to large caps, are neutral between value and growth (although we have seen some evidence suggesting that growth stocks are becoming more attractive on a valuation basis), and view foreign stocks as having similar return potential to domestic equities, assuming currency movements are not factored in.

For the past few years, many smart investment thinkers have been expecting interest rates to rise. While the Fed has driven short rates higher, rates have barely budged at the longer end of the yield curve. More recently, some experts (such as PIMCO's Bill Gross) have taken the view that it's now more likely that rates will remain low for at least the next several years. While the direction of interest rates is a key variable in fixed income total returns, it is important to recognize the difficulty in making this call correctly and the consequences if you are wrong. This is the reason that we think in terms of probabilities, and attempt to allocate our portfolios to perform well under our base-case expectation but also to provide protection in the event that big-picture risks (such as the structural problems in our economy) result in a difficult environment.

Those in the 'rates-will-stay-low' camp believe rates aren't likely to rise given that the only real demand globally stems from U.S. consumers, whose spending is partly fueled by an unsustainable inflation in asset prices such as homes. In the meantime, exporters from overseas are happy to sell us goods and their central banks loan the proceeds back to us by buying Treasuries, which keeps their currencies weaker than they would otherwise be versus the dollar, and keeps our interest rates lower, which in turn keeps asset prices inflating. Low rates depend on this environment holding together. But, in this type of environment it is also likely that:

- Weak growth in corporate earnings could easily discourage equity investors.
- Americans would still not be saving enough. This would be a big problem down the road, and it's hard to imagine the market wouldn't be reflecting this.
- The expansion of asset prices—both real and financial—would eventually require a correction at some point. It might not be within the next five years, but frothy asset prices combined with other structural imbalances would be a very dangerous mix and would likely mean much lower returns in subsequent years.
- All of these points could impact the risk premium—or excess return that investors require in exchange for taking on the risk of owning stocks. The return expectations generated by the mathematics of the model don't assume that investors might be more risk averse in this type of environment.

So while it's possible that low interest rates would keep the global economy on track and generate good stock market returns for a while, there are risks. We have a huge current account deficit relative to GDP that won't go away without an eventual dollar correction against the appropriate trading partners. While a dollar decline would traditionally lead us to expect an increase in inflation, we think the bigger impact could come from the decline in foreign capital inflows that have sustained demand for Treasuries and thus kept interest rates low. The absence of that demand could cause rates to rise, which further down the road might have a deflationary impact if consumption plunges due to the higher interest rates.

We think the most likely scenario (again, there is a high level of uncertainty in any scenario, so take "likely" with a grain of salt) is that earnings weaken from current levels, and that interest rates remain fairly low. A 10-year Treasury yield of 4%-5.5% over a five-year horizon seems quite plausible to us: this would involve low to average inflation of 2%-3%, lower-than-average real yields, but no global calamity (although we do think the dollar will weaken at some point). In this scenario, we'd expect the S&P 500 to generate average returns in the high single digits. But as we've mentioned before, there are other scenarios we can easily imagine that would lead to lower returns. For that reason, we have diversified many portfolios with small positions in commodities futures. Commodity futures will probably not perform well if a deflation scenario comes about, but in most other instances we expect them to add value.