INVESTMENT OUTLOOK

September 30, 2005

In recent investment reports to our clients, we have been expressing our confidence in both a continuation of the current economic expansion and further growth in corporate profits, "barring an unforeseen event". The ugly-sisters, Katrina and Rita, may prove to have been such an occurrence.

After the above expression of some uncertainty about the sustainability of strong economic growth, we should emphasize before going further that current business reports will be a less useful guide for the near future. At first, many economic releases were for the month of August and showed sustained strength in labor conditions, capital spending, manufacturing activity, and consumer expenditures. However, the hurricanes' impact effectively began in early September, and since then energy prices have remained high and consumer confidence has declined. Now we are starting to see mixed reports for September, some of which are quite negative, i.e., a spike in unemployment, a sharp increase in inflation, and lower industrial production. However, these data are distorted by specific conditions in the Gulf region and the sharp run-up in oil and gas prices nationwide. Conversely, core consumer prices, excluding energy and food, rose a milder than expected 0.1% in September. In sum, we cannot yet determine the complete national economic impact of the 2005 hurricane season.

While we have lost some conviction in the continuation of an extended economic expansion, in our opinion, the following outcomes are the most likely:

- Consumer spending will probably slow due to the depressing effect of higher energy cost
- Industrial activity should stay strong, because of both the impact of rebuilding activity after the storms and healthy overseas demand.
- Inflation will temporarily rise, reflecting higher energy costs and their influence on many other products. Moreover, it is possible that the fiscal stimulus of spending on storm recovery will push up prices to some degree.
- The surge in inflation may prove to be temporary. Recent wage settlements and competitive pressures from technology and imports suggest moderate employment costs may prevent core inflation from spiraling higher.
- Interest rates will rise further into early 2006, as the Federal Reserve continues to tighten towards 4.5% in an effort to offset the perceived threat of inflation.

We believe that the above conditions will not result in a recession, but will encourage an environment of moderate growth in economic activity and corporate profits. Both of these will be supported partly by the continuation of healthy employment conditions (after the Katrina evacuees become settled or are able to return home) and pent-up corporate demand for capital spending and well-trained employees. Moreover, the expenditure of enormous sums (estimated as high as $200 billion) to underwrite the rebuilding of the storm-ravaged areas will be a sustaining factor for the economy and corporate profits. In 2006 this stimulus, while inflationary and costly, will add to the national economic output much of what was lost in the third and fourth quarters of 2005.

The likelihood of continued growth in the economy and company earnings, combined with what is now a very reasonably-priced equity market (less than 15x a conservative estimate of 2006 earnings), provides an opportunity for stock market appreciation over the next year. However, such an upward move in stock prices might be delayed until investors become more confident in three aforementioned outcomes:

- Economic growth has not been aborted by recent events
- Energy-induced inflation does not accelerate into a broader inflationary malaise
- The current rise in short and long rates stabilizes at a level not much above where we are now.

In the meantime, among our investments, corporations like General Electric, Goldman Sachs, and PepsiCo have recently reported accelerated revenues and record profits in businesses as diverse as healthcare, alternative energies, investment banking, commodities trading, and food products. Their management teams have shown they can succeed in a range of economic climates. We are encouraged by the progress that most of our quality growth companies are making and believe that their superior long-term growth prospects are currently undervalued.