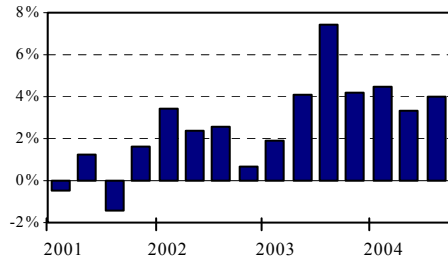


Fourth Quarter 2004 Highlights

January 2005
Issue 21

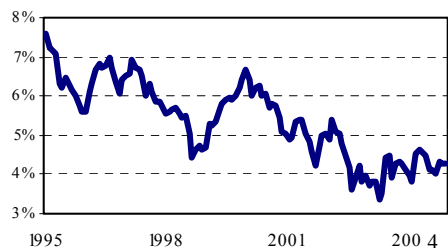
Real Gross Domestic Product, %change



Source: Baseline

GDP Growth Has Hit A Plateau

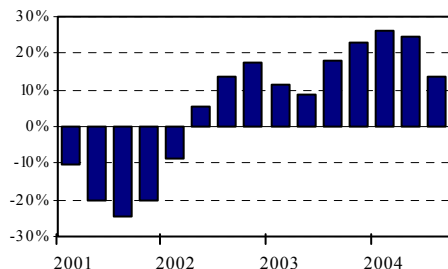
Ten Year Treasury Bond Interest Rate



Source: Baseline

Keeping Treasury Yields Constant

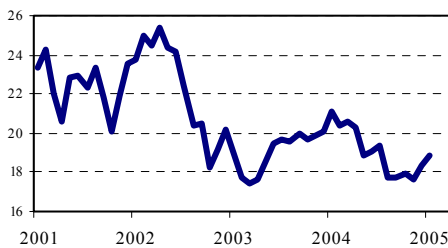
Corporate Profits, EPS %change



Source: Baseline

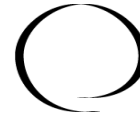
Corporate Profits Are Reverting To Normal

S&P 500 P/E Ratio (Trailing)



Source: Baseline

And Stock Market Valuations Remain Modest



OSBORNE PARTNERS

Capital Management

580 California Street, Suite 1900
San Francisco, CA 94104
(415) 362-5637
Fax (415) 362-5996

The Dollar and The Stock Market

By Charles D. Osborne
Justin W. McNichols
& Robert C. Gillooly

In the financial world the big story of the fourth quarter, outside of the U. S. election, was the 7% drop in the dollar against the Euro. This brought the total correction from the peak in early 2002 down 43%. Other dollar measures against a trade weighted currency bag were not as severe because many Asian countries, notably China, have a fixed exchange rate with us. Even so, the dollar is down 35% from the peak and is hovering near a twenty year low. But outside of higher prices for truffles and trinkets, what does this mean for our economy and for us as investors in the American stock market?

“In this cycle of dollar weakness, rising interest rates and rising inflation, the market has actually gone up.”

A Primer

A weak dollar has both positive and negative implications for the U.S. stock market. On the down side, a falling dollar is inflationary, and inflation is fought with higher interest rates, something the market does not like. Yet, a rising American stock market attracts international investors which leads to a stronger dollar. Still there are many other factors involved ranging from politics to profits. In this cycle of dollar weakness, rising interest rates and rising inflation, the market has actually gone up.

The Cause for the Dollar Decline

There is no single reason for the drop in the dollar; rather there are several contributing factors. We are running trade and budget deficits that are eating away at the growth of our economy. The rise of China as a power exporter, while having their external currency pegged to the dollar, has put a kink in the free market system of letting currencies rise and

fall to ameliorate trade imbalances. By letting their currency float, it would make their goods more expensive to Americans. Also during times when the dollar is weak, other countries whose economies are not as strong as the U.S., are not able to not pick up the consumption slack. Thus, private investors are demonstrating their lack of confidence in our collective ability to correct these trends by selling dollars and buying other currencies. Even Warren Buffet has a \$20B bet against the dollar.

Comparable Periods in Recent History

In the last period of significant dollar devaluation from 1985 to 1987, the market also went up until we ended with a sharp correction. We certainly hope that this will not be the case in 2005, yet there are many of the same problems. Our trade deficit and budget deficit are getting worse, and inflation and interest rates are on the rise.

	Trade Wtd. Dollar	Stock Mrkt S&P 500	Budget Deficit Prior Qtr.	Trade Deficit As % of GDP	Interest Rates 2 Yr Treas- ury	Infla- tion CPI	PE Rate Adj.
Jan-85	122	179	-59	-2.2	10.71	3.5	14.2
Sep-87	<u>78</u>	<u>321</u>	<u>-82</u>	<u>-3.0</u>	<u>7.86</u>	<u>4.4</u>	<u>22.1</u>
Change	-36%	79%	41%	36%	-27%	+26%	56%
Jan-02	107	1140	-97	-3.6	3.03	1.2	26.8
Dec-04	<u>89</u>	<u>1169</u>	<u>-131</u>	<u>-5.4</u>	<u>2.85</u>	<u>3.6</u>	<u>14.2</u>
Change	-17%	3%	36%	50%	-6%	+200%	-47%

The primary differences at this point are the extent of the dollar drop (much worse in 85 to 87) and the interest rate adjusted valuation of the stock market (higher in 87). On a relative basis, the dollar is 14% stronger than the pre-crash level. Finally, over the last twenty-five years the trade weighted dollar has been between 122 and 74 with a mid point of 98. It is presently at 90.

As we have witnessed in the past, a weak dollar is not necessarily a negative for the market, but it poses some significant challenges. The possible consequences of the weak dollar in the next year or so include the following:

1. U. S. interest rates creep up, the dollar strengthens, and our capital account surplus builds.
2. The U. S. Fed buys Treasuries in the open market, decreases the money supply, while rates go up along with the dollar and our economy slows.
3. U. S. consumption slows, which slows imports and the current account deficit begins to reverse as dollar priced products are inexpensive.

4. China raises rates or allows the Yuan to float. This would reduce their foreign exchange reserves and the dollar would have a final leg of weakness.

“On the down side, a falling dollar is inflationary, and inflation is fought with higher interest rates, something the market does not like.”

5. U.S. trims its budget deficit and investors regain confidence in our ability to manage our economy.

The outcome or the duration of the dollar decline from its peak is yet to be known. We do know that the stock market likes a strong dollar, but the dollar by itself is not a determinant of direction. Any or each of the above scenarios will have an effect on our economy. This in turn will impact companies and their earnings and their stock prices.

OPCM Contact Information:

Charles Osborne: (415) 627-0732 or 362-5637 x105
E-mail: cdo2@osbornepartners.com

Bob Gillooly: (415) 627-0736 or 362-5637 x104
E-Mail: bob@osbornepartners.com

Justin McNichols: (415) 627-0743 or 362-5637 x106
E-mail: justin@osbornepartners.com

Shannon Gallo-Lemon:(415) 627-0737 or 362-5637 x103
E-mail: shannoon@osbornepartners.com

Kirk Michie: (415) 627-0734 or 362-5637 x109
E-Mail: kirk@osbornepartners.com

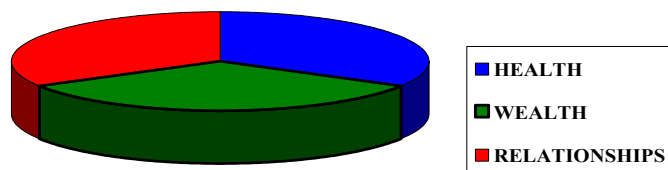
Brett Prior: (415) 627-0742 or 362-5637 x108
E-Mail: brett@osbornepartners.com

Christie Holmes: (415) 627-0738 or 362-5637 x110
E:mail: christie@osbornepartners.com

A Few Resolutions Worth Adding In Any Year

By Kirk Michie

By the time you read this piece, you're either diligently turning your New Years Resolutions into habits, or you have begun to revert to old habits and inertia in 2005. Most resolutions fall into three categories:



In the first and last categories, you have our best wishes for new or continued success, but we don't claim to have any greater expertise in those areas, so we'll stick with the middle area, **WEALTH**. All investors, whether accumulating wealth toward education planning for children, retirement planning for themselves or later stage investors focused more on retirement spending and estate planning, can benefit from a few basic but very critical guidelines. We would suggest that if you haven't already done so, that these items be added to your "Resolutions" for 2005.

1. **ASSET ALLOCATION:** Understand the impact of Asset Allocation on both return expectations, and portfolio risk.
 - a. Studies have continually validated the notion that *as much as 90% of a portfolios behavior (i.e. return & fluctuation) will be determined by the mix of stocks, bonds, cash, etc.* In light of that well documented concept, investors should adjust their mix based upon the need for growth, time horizon, and ability to tolerate fluctuations in value.
2. **TAX MINIMIZATION:** Where possible, shield your investments from taxes altogether, and when unavoidable, minimize the impact of taxes by:
 - a. *Maximize contributions to tax exempt or tax deferred accounts* to shield growth assets for erosion due to capital gains. From traditional IRA accounts to 401(k) and 529 Plan savings vehicles, the longer you can shield your growth assets from the multiple bites taken by the Federal & State governments, the more you'll have down the road.
 - b. *Target long term capital gains, offset gains against losses, and minimize trading* to reduce the likelihood of short term gains (taxed as ordinary income).
 - c. *If you are charitably inclined, make your gifts with appreciated property* (stocks, real estate, etc.) – this gives you the full fair market value as a deduction, gives the charity the complete value of the gift (qualified charities don't pay taxes), and avoids the payment of taxes on the capital gain by either party – it's a true "Win – Win".
 - d. *If you are gifting as part of your estate plans, make your gifts with appreciated property* as well – assuming you're below your exclusion amounts (couples can make \$22,000 per person gifts up this limit without paying gift taxes), the asset moves out of your taxable estate, and the recipient receives the benefit of the gift, and is likely to be in a lower tax bracket than you.

Be sure to consult your Tax Advisor on these strategies, as each investor's circumstance will differ somewhat.

3. **REVIEW YOUR PORTFOLIO & OBJECTIVES REGULARLY:** We encourage clients to meet with us at least twice per year, and encourage the participation of other Advisors (CPAs, Estate Planners, etc.) and involved family members. This helps to address several things:
 - a. Keeps expectations reasonable, and *measures progress against objectives.*
 - b. *Allows for mid course corrections* only as needed, and provides for reassurance against the vagaries of the financial markets.
 - c. *Provides a coordinated and consistent approach* to strategy, tactics, and results for each party involved.

While I mentioned at the outset that our specific expertise was best directed only toward the WEALTH portion of your New Year's Resolutions, you just might find that your HEALTH and RELATIONSHIPS benefit from these exercises as well. Happy New Year and best of luck in 2005!

Fixed Income Round-Up

By Robert C. Gillooly, CFA
& Brett J. Prior, CFA

<u>September 30, 2004</u>	<u>Yield</u>
Average Money Market	1.50%
5 Year AAA Muni Bond	2.82%
5 Year AAA Corp Bond	4.30%
10 Year AAA Muni Bond	3.70%
10 Year AAA Corp Bond	5.06%
30 Year Fixed Rate Mortgage	5.34%

In a Wall Street Journal survey conducted last February, 53 out of 55 economists predicted the yield on the 10-year Treasury Note would rise in 2004. The yield at the beginning of the year was 4.25%, and the economists on average predicted it to rise to 4.9%. On December 31st, the 10-year yield stood at 4.22%.



Many bond fund managers had similar forecasts. They expected the US economy to be strong, the Fed to raise rates, and long-term bond yields to rise significantly. This would bring bond prices down, and bonds with longer maturities would suffer the sharpest price declines. Armed with this prediction, many bond fund managers moved into shorter-term bonds. Contrary to their expectations, long-term bonds did better than shorter-term bonds in 2004, returning 8.0% vs. 2.8%. The bond managers that used a defensive strategy under performed their benchmarks. In retrospect, “staying the course” was the best strategy for fixed income in 2004.

What's New For 2005

By Shannon S. Gallo-Lemon, CFP®

Annual contribution limits for qualified employer-sponsored plans and IRA contribution limits have increased for 2005. With those changes, the beginning of the year is the perfect time to increase your contributions to take advantage of the additional retirement savings opportunities.

Deferral Limits for 403(b) and 401(k) Plans

Dollar Limit \$14,000 (Increased by \$1,000)

Catch-up Contributions for 403(b) and 401(k) Plans for individuals over 50

Dollar Limit \$4,000 (Increased by \$1,000)

After your full contribution of \$14,000 has been made, then the additional \$4,000 catch-up contribution can be made. This even holds true if your contributions are capped because you are considered a highly compensated employee (HCE). One frequently asked question I get is, “Can I write a check for my catch-up contribution?”. The answer is no, all 401(k) contributions must be done through payroll deductions. So if you want to take advantage of the catch-up contribution, you must plan your catch-up contribution by calculating an annual payroll deduction of \$18,000 for the entire year.

Deferral Limits for IRAs (Both Deductible and Non-Deductible)

Dollar Limit \$4,000 (Increased by \$1,000)

Catch-up Contributions for Deductible IRA's for individuals over 50

Dollar Limit \$500

Another change is **Higher Income Limits for Deductible IRAs**. If you are covered by a retirement plan at work, you can take an IRA deduction if your modified adjusted gross income is less than \$80,000 (married filing joint) or \$60,000 (single or head of household).

Deferral Limits for SIMPLE Plans

Dollar Limit \$10,000 (Increased by \$1,000)

Catch-up Contribution for SIMPLE Plans for individuals over 50

Dollar Limit \$2,000