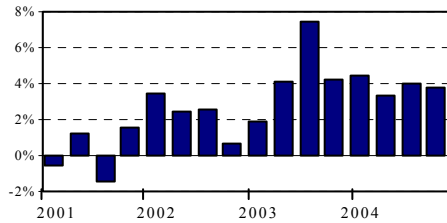


## First Quarter 2005 Highlights

April 2005  
Issue 22

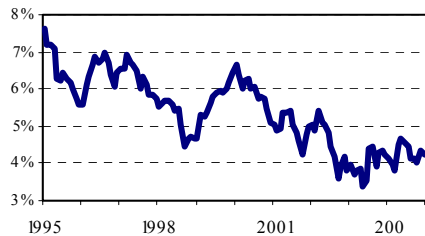
Real Gross Domestic Product, % change



Source: Baseline

### GDP Growth Continues To Be Robust

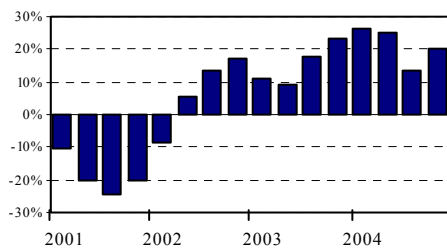
Ten Year Treasury Bond Interest Rate



Source: Baseline

### But Treasury Yields Are Now Inching Upward

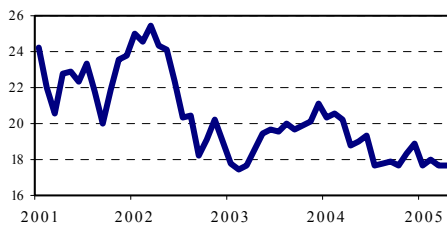
Corporate Profits, EPS %change



Source: Baseline

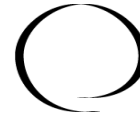
### Strong Profits Have Fueled Capital Investment

S&P 500 P/E Ratio (Trailing)



Source: Baseline

### Stock Market Valuations Are Still Attractive



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## The Sword of Damocles CEOs and the Market Malaise

By Charles D. Osborne

The sheer number of fired iconic CEOs in the first quarter was astounding. Hank Greenberg at AIG, Michael Eisner at Disney, Harry Stonecipher at Boeing, Carly Fiorina at HP and Franklin Raines (in December) at Fannie Mae, were all given the boot. Martha got out of jail but Bernie is going in. Now even Warren Buffet is under the gun. A total of 200 chief executives of large public and private companies have lost their jobs. This was not coincidental to a weak stock market. The boards of directors' actions reflect a general dissatisfaction with corporate executives.

We cannot have a decent stock market when we have little confidence in earnings quality or in the management of the companies. Chief Executive Magazine says that an astounding 87% of the American public feels that CEOs are not to be trusted. The images of CEOs going into and coming out of jail, standing trial for fraud, being accused of cooking the books to impress investors, and their greedy excessive contracts, all reinforce this negative image. There seems to be little that can be done to correct this view although the vast majority of large corporations are

run by honest and ethical people who actually have the shareholders' interests in mind.

### Making the Manager an Owner

There has always been a built in conflict between owners and employees, which in this case is shareholders and management. The problem throughout time has been, how does the owner ensure that the manager is on their side? Louis Kelso invented ESOPs in the 1950's in part to deal with this struggle. Then in the 1980's, leverage buyout funds allowed management to buy companies. The concept of putting executives on the same side as shareholders, by giving them options to purchase stock, started to be very popular. Corporate boards saw options as a way to attract top management, when the stock market was booming. The problem was that managers saw all these attempts as just additional compensation that was off the books and some also felt the pressure to keep the stock price up at any cost.

### Superstar CEOs

Managers such as Lee Iacocca and

Jack Welch became superstars in corporate America, but they were few and far between. Their image however became the paradigm for the manager everyone wanted and was willing to pay for. The enrichment of management, at the expense of shareholders, now hangs over their heads like the sword of Damocles. Just like the ancient story of Damocles, envy of Dionysus’ wealth and power, they have it all, but at their peril. Making them shareholders and creating this myth of the superstar CEO, along with the pressure of quarterly performance, has led too many executives to manipulate earnings to keep up the stock price.

**Fixing the System**

Since the frauds, scandalous behavior, and evident greed were uncovered, there have been several attempts to correct the system. Activist shareholders have called for independent boards and more reasonable pay for CEOs. Congress passed the Sarbanes Oxley bill and the SEC created Regulation FD to make managers more open and responsible. The FASB created accounting rules that now include demonstrating the effect of options on financial statements. Courts have held individual board members responsible and also personally liable for corporate misdeeds; investment bankers have had to pay for not doing sufficient and appropriate due diligence in merger and acquisitions. These actions are going a long way to help, but need furthering. Time without more evidence of misdeeds will help too.

These efforts should eventually bear fruit, as our system is very solid. The economy is clearly slowing down thanks to higher oil prices and higher rates, but it is still a powerful engine of growth. The stock market remains reasonably valued given this growth and the absolute level of inflation and interest rates.

**To Index or Compete -  
That’s the Question for your  
Investment Advisor**

*By Kirk Michie*

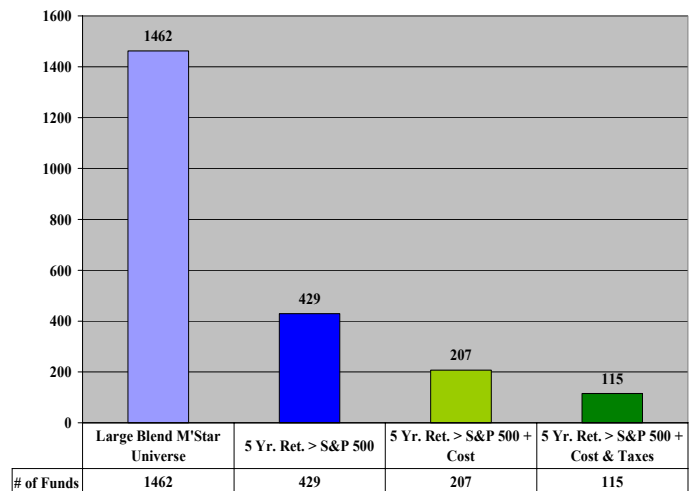
There is a growing divide in the investment community over the issue of whether passive or active investing is the better approach. The debate, which is not so much different than the Value v. Growth argument, has very high profile academics and professionals on both sides. A brief synopsis of the argument:

- | Active v. Passive - Framing the Debate                 |
|--|
| 1. Market Like Returns v. Potential to Beat the Market |
| 2. Costs   |
| 3. Taxes   |
| 4. Professional Support v. Academic Support            |

First, to state the obvious to any of our clients, we are an *active investment manager*. While we don’t believe that clients should or do hire us purely for this reason, we believe that one of the by products of our approach is the fact that we can (and do) outperform our benchmarks through time. For purposes of objectivity, let’s set that aside for now.

Second, let me state another point that may be less obvious, but more important. The most critical issue in protecting and productively using your investments is the allocation of your assets. It is not whether you attempt to outperform a benchmark, employ a particular style, or utilize individual securities. In the hands of capable professionals, and disciplined individuals, each of these methodologies will work, but without the appropriate mix of stocks, bonds & cash for your unique circumstances, none of these choices will save you.

**On Point # 1 - Can Active Management Beat the Market?**



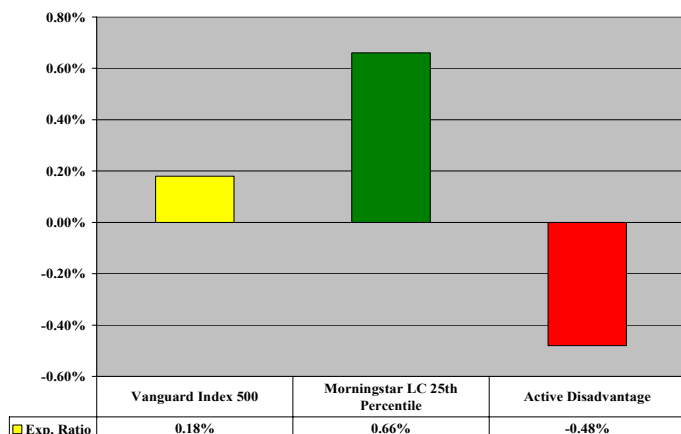
Reading from the left, there are 1462 Domestic Large Blend managers in the Morningstar Universe, and over the past five years, 429 (29%) have beaten their S&P 500 benchmark for performance. So, on Point # 1, with nearly 1/3 of professional investment managers outperforming a very difficult benchmark with a neutral style, there’s still a very compelling case for active management – nearly one in three, and many of those managers have excellent longer term records as well.

Is there a compelling case to be made for indexing as well?

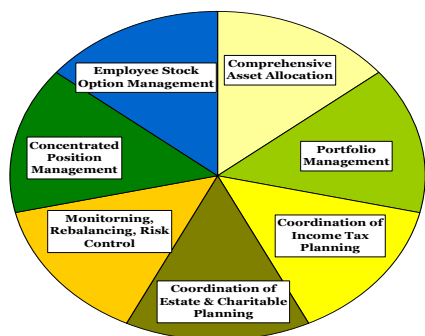
Sure, but most of us didn't become successful by playing to a "tie" – we want to "win", and active management gives us that opportunity, and passive investing cannot.

**Point # 2 – Costs. Or, Do Active Managers Charge Too Much?**

By contrasting the most popular passive mutual fund with the average large cap blend (active) fund on cost alone, active appears to be at a severe disadvantage. If however, we looked at the more cost efficient segment of that high performance group in the previous chart, the data looks a bit different:



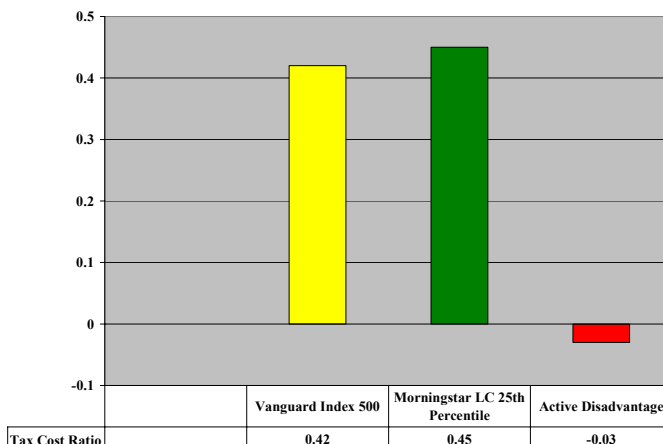
The additional cost of active management is less than one half of one percent. When one considers the additional services that professional wealth manager's offer to their clients (see next graphic), receiving those additional services for 0.48% is a bargain. Try calling Vanguard's toll free line to get professional advice & counsel on any one these areas – much less all of them!



**On to Point # 3 – Taxes. Or better stated, passive investing minimizes taxes more effectively than active management.**

Comparing the most popular passive approach (Vanguard Index 500 Trust) to the more tax efficient managers in the top

performers in the first chart, we get the following data:



Any argument that hangs on just three one hundredths of one percent doesn't really require much opposition. By regularly offsetting gains against losses, keeping turnover low, and maintaining a team approach to planning with a client's tax advisor, your wealth manager should comfortably add well in excess of 0.03% of additional value.

**On Point # 4, let's call it a tie – neither camp can argue conclusively, and that fuels rather than resolves the ongoing debate.**

We believe that it is important to illustrate the foregoing argument in favor of active management so that clients will not pay too much attention to the approach, and lose sight of the most important elements of protecting and growing wealth. Count on us to continue to provide a consistent and disciplined message, and remember a few key things:

1. Both Value and Growth can work – what's important is sticking to one or the other for consistency.
2. Passive and Active can be equally effective – it's the wealth management issues surrounding these approaches that will ultimately drive your success as investors.
3. Asset Allocation Trumps All of the above issues. Stay focused on that, and the rest will fall into line to balance both risk and return to your comfort and expectations. Both sides of the debate often site the same evidence, the work of Messrs. Brinson, Hood & Beebower, "Determinants of Portfolio Performance", Financial Analysts Journal vol. 42 (1986), which suggests that in excess of 91% of portfolio performance is explained by "Policy", or Asset Allocation. On that point, we agree, and it is that point which is most important to your long term success as investors.

As always, please call us at (415) 627-0734 or email [Invest@Osbornepartners.com](mailto:Invest@Osbornepartners.com) if we can provide any assistance on investment and financial planning (Wealth Management).

# Fixed Income Round-Up

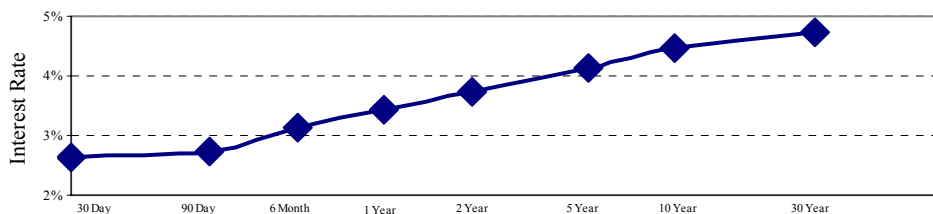
By Robert C. Gillooly, CFA

Treasury Yield Curve

March 31, 2005

Yield

Average Money Market	2.00%
5 Year AAA Muni Bond	3.34%
5 Year AAA Corp Bond	4.67%
10 Year AAA Muni Bond	3.97%
10 Year AAA Corp Bond	5.13%
30 Year Fixed Rate Mortgage	5.52%



As anticipated, bond yields rose in the first quarter of 2005. The Federal Reserve has met twice this year, each time raising short term rates by .25%. This leaves their Fed Funds lending rate at 2.75%. This upward movement has a meaningful impact on money market rates, which have finally risen to the 2% level. Money market rates typically lag what the Fed does, so investors can expect further improvement in yields over the next few months.

Long-term bonds, on the other hand, have not moved in lock step with the changes the Fed has made. The 10 year bond has modestly moved from a 4.26% yield at the end of 2004, to 4.48% on March 31<sup>st</sup>. Long bonds typically are more sensitive to inflation data, so investors can take heart that the modest increase in yields here appropriately reflect the subdued consumer inflation our economy continues to experience. As long as Alan Greenspan continues to use the word “measured” when describing the pace of interest rate increases, we expect the bond market to react accordingly, slowly pushing up interest rates similar to the way it has done over the past three months.

## Retirement Planning Tips

By Shannon S. Gallo-Lemon, CFP®

According to a Gallup survey taken in 2004, 52% of adults in the U.S. worry about not having enough money for retirement. To help ease some concerns, the following tips will help you get in gear saving for your retirement:

**Start Planning Now** - The key starting point in reviewing your retirement needs is to determine an accurate estimate of your expenses during retirement. Many pre-retirement expenses will end once you retire, such as business lunches, etc., but other expenses may increase. Travel and leisure activities become new expense items with the later part of retirement including increased health care costs and reduced leisure expenses. As a general rule of thumb, your retirement income should be estimated at 80% of your pre-retirement income lifestyle.

**Invest in your 401(k)** - This is the best place to put money away for your retirement. Try increasing your annual contribution limit to \$14,000 to take advantage of the maximum contribution allowed or increase your contributions by 1-2% per year, all the while reducing your taxable income and receiving the maximum amount from employer contributions.

**Remember Allocation, Allocation, Allocation** - If you have plenty of time to handle the shifts in the market, you will want to invest more aggressively (80% equities, 20% fixed income), however, if you are closer to retirement, you will want to invest more conservatively (70% fixed income, 30% equities). A great rule of thumb is called the “*Six Pack Approach*”: *one large-cap fund, one mid-cap fund, don't forget a small-cap fund, toss in an international fund, add a bond fund and finish it off with a money market fund.* Being diversified has a bigger impact on your long term returns than the funds you choose.

**Out of Sight, Out of Mind** - The best way to be consistent with any investment program is to go automatic. Automatic payroll deductions make it easy to save in your 401(k) plus if you begin slowly increasing your 401(k) deductions, after a few pay days, you will adjust your spending. Also consider investing elsewhere for retirement. Many mutual fund companies will allow you to open an account with a small initial amount if you sign up for automatic monthly contributions.

**You Can Borrow Money For College but Not for Retirement** - Saving for your child's education can be a priority but start by planning early. Invest in a 529 Plan for your child or have your child tap their savings reserves before you tap yours. Having your child borrow some or all of the money needed for college is not always a bad thing; they will have a much longer time period to pay the money back than you will have to replace the funds for retirement.

Make retirement planning a priority. Devise a plan, stick to it and set goals for yourself, you will be glad you did in the long run.