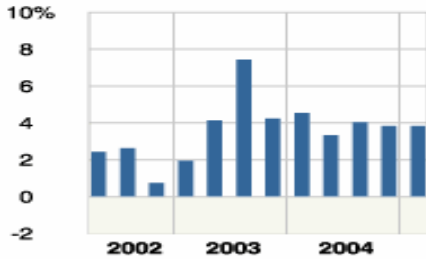


**REAL GDP**

Change from previous quarter at annual rate, seasonally adjusted



Source: Department of Commerce

**UNEMPLOYMENT RATE**

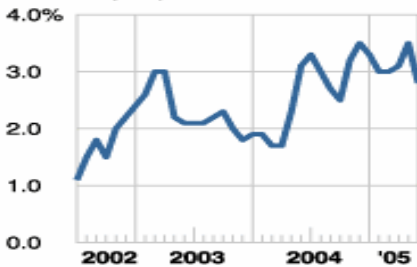
Seasonally adjusted



Source: Bureau of Labor Statistics

**CONSUMER PRICES**

Change from previous year, not seasonally adjusted



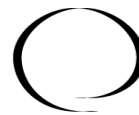
Source: Bureau of Labor Statistics

**EXISTING-HOME SALES**

Annual rate, in millions of units, seasonally adjusted



Source: National Association of Realtors



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**Home Prices and Stock Valuations**

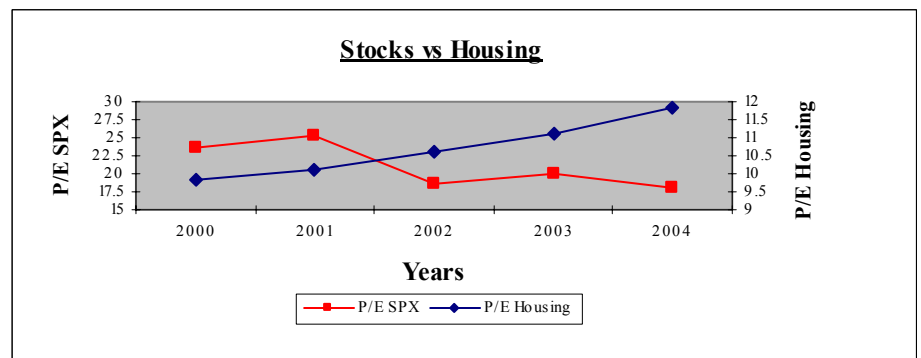
*By Charles D. Osborne*

After reading countless articles on the ‘housing bubble’ I have an overwhelming urge, as many of you may do, to run out and sell my home to catch the top of the market. Then I remember I need a place to live. That, in essence, is why the bubble will not burst, but more likely will slowly deflate. People need a place to live. It is expensive to move, and if prices start to drop, many sellers will simply remove their homes from the market.

Before I became a securities analyst, I was a real estate appraiser for Crocker Bank. That was in 1971 and 1972. We had a simple rule back then for calculating appreciation: houses increase 5% in value every year, only kitchen and bathroom improvements and additional square footage added value. In fact this has been true, in general, since WWII. Specific areas would blow hot and cold, but the national average was 5% every year. As we all know that has changed in the last four years.

Ever since mortgage rates started to plummet, the housing market has been on fire. Even more than the stock market, the P/E of housing (value divided by fair rent) responds to interest rates. Existing home sales and new housing starts have been extremely strong, even during the recession. Housing typically is hit very hard in a recession, but the affordability created by low rates has kept demand alive. Now, after nine increases in interest rates by the Federal Reserve, and four years of 7+% average increases in existing single family home prices, it is quite likely that at best we will have a flat market for some time.

P/E ratios, whether in the stock market or housing, are excellent gauges of value. Right now the housing P/E is about 35% above normal, while the stock market P/E, when compared to interest rates, is about 14% below average.



The rise in existing home prices coupled with stable rents on those homes has created a new high for housing multiples, while the stock market continues to hover near a 5 year low.

We are not alone in this housing run. According to The Economist magazine, four-

teen countries have experienced above baseline rate increases. Of these, we are just number six over the last year. The world housing market was valued at approximately \$70 trillion as of the end of the year. That is up from \$30 trillion in 2000. England, for example, had a tremendous run-up of 154% since 1997 (U.S. is up 73% in the same time period), but is now experiencing its ninth month of declining prices. Over half of the U.S., in terms of value, has seen existing home sales in the 'bubble' range. That includes 55 of the 362 metropolitan areas.

The question for us is how the inevitable drop, and we do think it is inevitable in many areas, will affect the stock market. We know the economy will be negatively impacted. Two out of the five jobs created in the last five years have been housing related. Certainly that growth will not continue. People have mortgaged their homes to spend money on a variety of things. This source of cash will be vastly reduced. The speculation on homes as investments (a total of 23% of last year's transaction) and vacation homes (13% of transactions) will be less enthusiastic. Why? The Fed procedure of gradually raising interest rates has flattened the yield curve and added pressure on the expense side of consumer spending. The Housing Opportunity Index, a measure of affordability determined by average income and mortgage rates, is at an all-time low after coming from an all-time high in 1999. There are however, some positives in our economy.

Job growth and wages, capital spending, and exports are all improving. According to Alan Greenspan, this will offset the drag on consumer spending created by a slowdown in housing. As corporate earnings correlate to GDP growth, that half of the stock market valuation equation should be neutral. The other hard variable is interest rates.

If an interest rate spike does not occur (See Justin McNichols' column) and earnings continue to improve as expected, we could see a decent stock market despite falling home prices in some areas. There has never been a year of nationally declining existing home prices since the depression, and we are not in a depression. The trends that created the housing boom are mostly still in place, just weaker. Namely there is increased demand due to household growth, immigration, and low mortgage rates. Although there are geographic pockets of speculation and high prices, nationally the housing market is fine. In fact, nationally for the decade to date (5 1/2 years) the median new home price is up only 7% per year (\$161,000 to \$223,000) versus a 6.3% average over the last fifty years. This leads us to believe that despite the high prices there will be no dramatic national decline in home prices, but more likely a slow revaluation.

If there is no bursting housing bubble, and we continue to see relatively low interest rates and a stable economy, then all the factors are in place for above average returns in the stock market.

## Five Reasons Interest Rates May Not Spike

*By Justin W. McNichols*

With all of the recent talk about future rising interest rates derailing everything from the economy, to the housing market to the stock market, I felt compelled to digress from my normal equities topics to author a piece on interest rates. The overwhelming common interest rate thesis today is that the Fed will continue to raise the Fed Funds rate, the economy will slide, and the dollar will continue to weaken. A typical projection calls for 10-Year U.S. Treasury rates to climb to 6% or more. This is an interesting textbook thesis, however, one should always be wary of a consensus opinion.

After thinking about "the inevitable spike in interest rates", I began to formulate a thesis against a spike in rates. Many parts of the "anti-spike" thesis not only make sense, but also have a strong probability of occurring. My thesis was compiled using evidence from the past, present, and future, and contains a total of five reasons.

**Reason 1: The Past.** - I have the simple belief that due to the combination of a recession and an outside shock (terrorist attack), the Fed overshot to the downside when the Fed Funds was reduced from 6.0% to 1.0%. Since then, to avoid an overheating economy and inflation, the Fed has raised the Fed Funds to 3.25% over the last year. Typically, the first rate hike affects the economy about 9-12 months out, or early 2005. There is evidence the economy peaked in 2004 by registering 4.4% GDP growth. 2005 will most definitely be under 4%. Additionally, Core PPI and Core CPI may have peaked in February and March respectively. The Fed's goal was achieved, and the Fed Funds Rate does not need to be higher than 3.50% or so.

**Reason 2: The Past** - If one views a 30-year chart of the Fed Funds Rate, a pattern emerges. The Fed routinely overshoots during easing and tightening cycles. When you manually exclude the overshoot periods, you can draw a fairly consistent band between a Fed Funds Rate of 3.0% and 6.0%. The basic thought is that the Fed Funds Rate is now in its normal range, and further hikes from here will not be as quick to occur.

**Reason 3: The Present** - Joining the bear consensus on interest rates is fairly easy until one looks at the Treasury yield curve. Most of the time, the yield curve provides an accurate view of likely future events. One year ago, the yield difference between the 10-year and the 2-year Treasury was approximately 2.00%. Today it is 0.30%; basically indicating an investor receives only a 0.30% higher interest rate by owning a bond that matures in 10 years versus 2 years. A curve this "flat" is rare, but the last two times we saw this scenario were early 2000 and early 1989 – just prior to a slowing economy. To avoid a repeat of 1989 and 2000, the Fed should/will slow or stop their tightening cycle.

**Reason 4: The Future – Consumers** - Thousands of consumers took advantage of low interest rates in 2003 and 2004, and

either refinanced their homes or bought larger, more expensive homes. According to the mortgage refi index, a record \$2.5 trillion of residential mortgages were repriced. Many economic teams\* have estimated that \$750-\$800 billion were ARM refis, while the average ARM term is in the 3.00-3.25 year area. With an estimated \$450-\$500 billion of mortgages up for renewal over the next year, rates need to stay low, or obviously all of these refis will be at higher rates. To avoid a consumer debt crunch over the next year or two, the Fed may be very careful about the level of the Fed Funds Rate, and how it affects the 10-Year Treasury.

**Reason 5: The Future – The Dollar** - Recently, the dollar began to appreciate after a three-year decline. Against many currencies, the dollar reached decade long lows. To assure the dollar slide is history, the Fed should be very careful to keep rates in line with other countries to avoid interest rate parity from taking over, thus hurting the dollar again. The basic idea behind interest rate parity is that future currency exchange rates are a function of present interest rates. In comparing two countries, the country with the higher present interest rate will see its home currency depreciate in the future.

The preceding reasons, coupled with a secular increase in demand from countries like China and India, could actually keep interest rates range bound for a period. While the consensus believes the 10-year Treasury is headed toward 6+%, the minority who feels rates will be range bound at lower levels may be correct over the next year. \* *Merrill Lynch. ISI Group.*

## Managing Risk By Managing Ourselves

*By Kirk Michie*

Investors come in all different types and sizes, and as much as each client has truly unique and different circumstances, all become more alike in one area – the desire to minimize or eliminate RISK! The good news is that if we can come together on which risks we seek to control, then our chance of success rises exponentially. We'll look below at three common risks that seem to trouble most investors. These first two risks are characterized by Behavioral Economists as *utilitarian*, and the final risk as *expressive*.

In the 30<sup>th</sup> Anniversary Issue of the *Journal of Portfolio Management* (copyright 2004), Meir Statman, a leading Behavioral Economist explains the difference in terms of restaurant choices. "Restaurants offer food to those who cannot cook at home or do not wish to. But why do we pay \$160 for dinners at Alain Ducasse (or perhaps locally, Chez Panisse), a very special French restaurant, when equally nutritious meals are available at neighborhood restaurants for \$20?"

Let's look at each risk and the corresponding strategy for reduction.

**1. Risk of Permanent Loss (*utilitarian*)** – For an investor with his or her entire portfolio in *Enron* or *WorldCom*, this was and is a very real threat, and is a palpable tragedy for their families.

To minimize, and arguably eliminate this risk one need only remember a few important lessons, and to consistently apply the following disciplines:

- Don't put all your eggs in one basket. Modern Portfolio Theory (*Journal of Finance* 1952 – Markowitz) teaches us that having at least 20 stocks in a diversified portfolio moves the risk of owning one company toward that of owning the entire market – a substantially safer proposition.
- Add the discipline of Investment Policy, or Asset Allocation and you have further reduced this risk by owning other asset classes (i.e. cash, bonds, foreign stocks, real estate, gold, etc.), and both chance of loss and volatility plummet.

**2. Risk of Capital Insufficiency (*utilitarian*)** – This one is a bit tougher, but manageable nonetheless. Planning for a specific goal (i.e. college education or retirement) must take into account beginning asset values, possible additions, expected returns and variability, and the timeframe to withdrawal. The primary dangers are underestimating the assets necessary to meet the goal, overestimating likely returns, and not understanding your own tolerance for variability/volatility.

Most professional investment advisors have tools, commonly referred to as mean-variance-optimizers to dimension and control these variables. While asset returns are subject to a great deal of variability in the short run, they are much more predictable over the long term, and all investors can greatly benefit from maximizing the time necessary to meet their objectives. Developing a strategy for substantially minimizing and more completely understanding both of these risks should cover the majority of the investment issues that keep us awake nights.

**3. Relative Risk (*expressive*)** - While no less significant to many investors than the foregoing issues, this risk is much less likely to cause one to postpone retirement, or change his or her lifestyle. As competitive people, we want to make sure that we do the best that we can, and we seek to maximize that likelihood. While pursuing better returns and more effective tactical mixes of assets is certainly a worthwhile goal, chasing performance, trading too often, and altering long term strategy for short term gain are three of the most common and detrimental behaviors of unsuccessful investors.

This risk is completely controllable by managing one's emotions and decisions in two specific ways:

- Make your asset allocation decisions for the long term, and avoid changing course unless there are material changes in your lifestyle or investment objectives.
- Choose your advisors, funds, or investments based upon the longest possible track records, and make your peace with short term underperformance from time to time. Good investors (professional and non-professional) tend to be persistent out performers over the long term, but strong short term performers rarely repeat.

All risks are better controlled or avoided by understanding their nature, and employing tried and true techniques to manage. As always, let us know if we can help to clarify or refine these concepts to fit your unique circumstances.

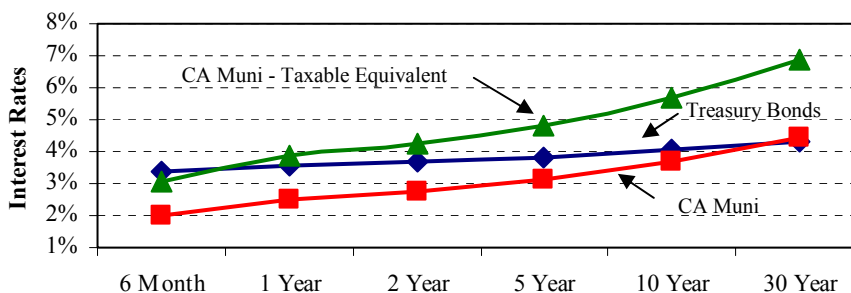
# Fixed Income Round-Up

By Robert C. Gillooly, CFA

Yield Curve Comparison - 7/7/05

## July 7, 2005

	Yield
Average Money Market	2.25%
5 Year AAA Muni Bond	3.13%
5 Year AAA Corp Bond	4.37%
10 Year AAA Muni Bond	3.71%
10 Year AAA Corp Bond	4.80%
30 Year Fixed Rate Mortgage	5.19%



As anticipated, short-term bond yields continued to rise in the second quarter of 2005. The Federal Reserve has raised short rates nine consecutive times over the past 18 months, each time raising them by .25%. This leaves their Fed Funds lending rate at 3.25%, with additional increases likely forthcoming. This upward movement has created an extremely flat yield curve, which implies investors are not well rewarded for purchasing longer term bonds at the moment.

The enclosed yield curve is an excellent example illustrating the benefits of municipal bonds. In this chart, if an investor purchased a 10 year muni bond, versus the alternative of a 10 year U.S. Treasury, their after tax yield would be 1.67% higher (assuming a 35% bracket). The conclusion here is clear; for investors who do not require a high amount of current income and fall into a higher tax bracket, municipal bonds are attractive.

## Protecting Your Financial Identity

By Shannon S. Lemon, CFP®

One of the best ways to protect yourself from identity theft is to be proactive and monitor your credit history. Effective December 1, 2004, a new law was passed that allows Californians and other consumers to get one free credit report a year from each of the three national credit bureaus: Equifax (800-525-6285), Experian (888-397-3742) and Trans Union (800-680-7289). All three credit reports can be requested at once or you can in essence, create a no-cost version of a credit-monitoring service. To start, request your free credit report from Equifax first, four months later request another free copy of your credit report from Experian and finally, four months after that request your final credit report from Trans Union.

*Other ways you can protect your identity are as follows:*

- Erase your paper trail – Shred your documents before you discard.
- Do not share information – Ask financial firms not to share your personal information.
- Be aware of phish – Never click on a “hot link” in an email that requests personal information be submitted.
- Watch billing cycles – If you miss receiving a monthly statement, this could be an indicator that someone has redirected your statement.
- Protect your mail – Send bills from a locked box only and remove your incoming home mail immediately, if your mailbox is not secure.

*If you think your identity has been compromised, the Federal Consumer Information Center recommends the following:*

- File a fraud alert – Contact each of the three credit rating agencies to place a 90 day alert on your account. Ask to be notified before any new accounts are opened or changes are made.
- File a police report – You will need to file a police report to extend your fraud alert for seven years and correct your records.
- Close accounts in question – Request the account in question be closed and marked “closed at consumer’s request”.
- File a complaint at [www.ftc.gov](http://www.ftc.gov)

Finally, one additional tool available to Californians to protect against identity theft is “freezing” your credit files with the three credit bureaus. Freezing simply means that your credit files are frozen, and anyone who has your name and social security number will have a hard time opening an account in your name because access to your credit data is limited. So, if you are a victim of identity theft and have a police report, you are able to “freeze” your credit for free, otherwise, it costs \$10 to place a freeze with each credit bureau. By following these suggestions, you can minimize the likelihood that you become a victim of identity theft.