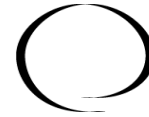
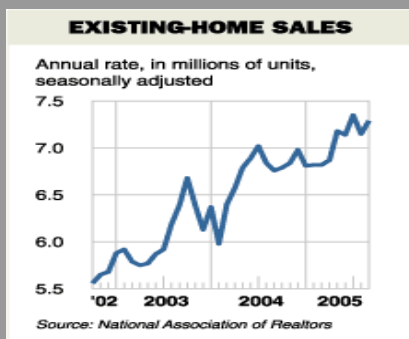
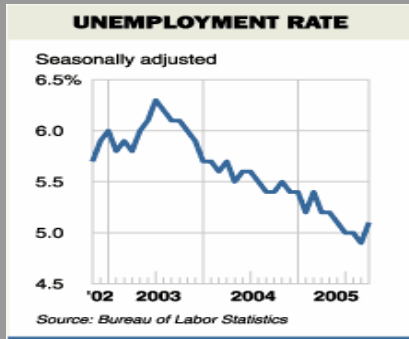
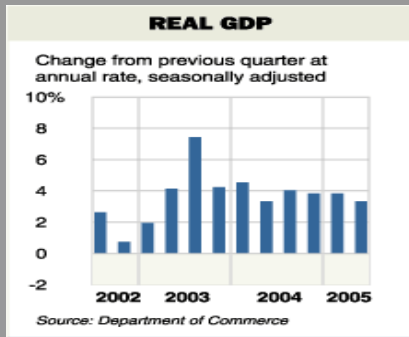


Third Quarter 2005 Highlights

October 2005  
Issue 24



# OSBORNE PARTNERS

## Capital Management

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

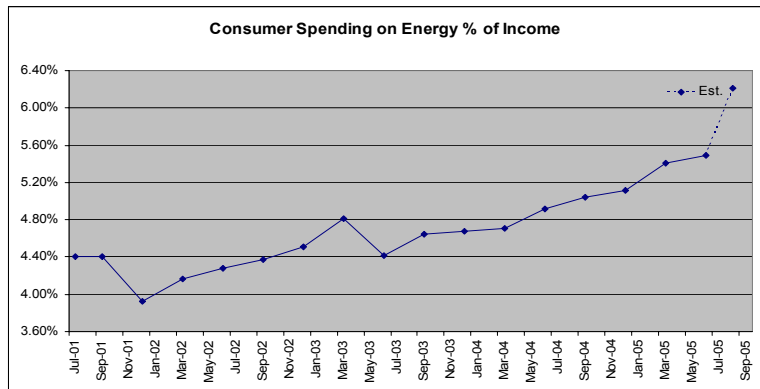
## Energy Storms

By Charles D. Osborne

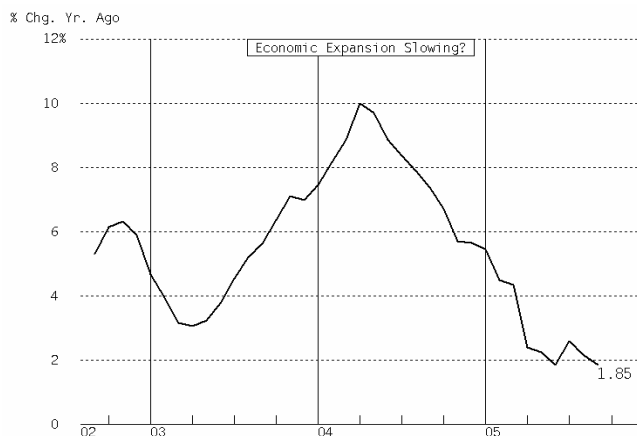
The devastation of New Orleans dominated the third quarter, and the effects are still being debated. Although this was (hopefully) a one time event, it accelerated some trends that were developing and pointed out some structural weaknesses in our system. Rising gas prices were taking a bigger bite out of consumer paychecks before the hurricanes and our economy was slowing down. Unless we develop some alternative energy source this problem will repeat itself.

The hurricanes caused havoc with our economy and were politically destabilizing. Even after the government plows one hundred billion dollars into the areas affected and private insurers and others put another hundred billion into rebuilding, we will lose at least fifteen percent of our expected economic growth this year. The economy was already showing signs of slowing and sustained high energy costs will outweigh massive government spending. The lack of ability to deal with this crisis was difficult to comprehend for many Americans. It is not surprising that consumer sentiment has plunged. We have allowed ourselves to be vulnerable to high energy costs in times of slowing economic growth.

The depressing fact of three dollar gas prices highlights a fundamental problem with our system. Our dependence on oil as our sole energy source is the weakest link in our economic chain. Energy costs are now expected to reach an unprecedented six percent of disposable personal income. This crowds out other spending. If you spend sixty dollars filling up your SUV, you won't be so adventuresome at Wal-Mart.



The trend of oil prices has been up all year, despite large inventories of crude oil. In our last memo we detailed the lack of refining capacity that contributed greatly to this situation. Even if oil prices retreat sharply from here we expect gas at the pump to stay at current levels until inventories are replenished. This will certainly have an effect on economic growth as best demonstrated in the leading indicator chart.



### WORRIES ABOUT INFLATION?

In the last year we have seen many inflationary forces, but the absolute level is still moderate and the bond market has been stable. A weak dollar, rising commodity costs (especially oil), deficit spending, trade deficits and full employment are all inflationary. On top of the cost of the Iraq war and run-away home prices, we understand the Federal Reserve's decision to raise interest rates for the 11<sup>th</sup> consecutive time. The Fed clearly is taking preemptive measures to combat inflation before it spreads to other sectors of the economy. Yet expectations of inflation are still low. After twenty-five years of fighting the inflation battle the Fed may be able to claim victory. We just spend less now without fearing higher prices tomorrow.



### CONCLUSION

Government spending and other forces should keep us out of a recession next year, but growth will be low. The cost of energy saps our ability to save and invest. Although inflation appears tamed, long term growth has proved illusive. We clearly need a productive new stimulus on the scale of personal computers in the eighties or the internet in the nineties to provide real growth. We personally would welcome some serious attention to exploring a viable alternative to oil as an energy source. Not only would this help alleviate future bottlenecks, but it would also encourage additional capital spending. Until a catalyst like this takes effect, we will continue to be dependent on fiscal stimulus to provide growth and be vulnerable to shocks such as Katrina and Middle East politics.

## Exchange Traded Funds (ETFs)- Old Wine in New Bottles, or the New New Thing? -Part I of a II Part Series-

*By Kirk Michie*

Over the past several years, the fastest growing investment vehicle segments in financial services are Hedge Funds and Exchange Traded Funds (or ETFs). Inasmuch as Hedge Funds, or alternative investments are associated in most investors minds with both high risk and high return (often incorrectly – more on that in Part II), and most ETFs are indexed or market linked products often associated with lower risk (also, often incorrectly), and lower costs (correctly), this would seem to be paradoxical. From our standpoint as investment advisors to both individual and institutional clients and their consultants, it's perfectly logical. Our mission, in simplest terms is to position our clients to control risk and maximize return commensurate with investment objectives and personal or organizational circumstances. When used appropriately, both vehicles allow us to do just that – achieve better returns at lower risk.

According to research from Tiburon Strategic Advisors, there were more than 170 ETFs in circulation as of September of this year, up from just 30 of them in 1999. In that same period of time, asset growth has soared from \$34 Billion to \$226 Billion. And while mutual fund sales still dwarf ETF adoptions (net sales of mutual funds of \$144 Billion versus \$57 Billion for ETFs in 2004), ETFs now account for just under half of all market linked fund products in existence. Even Vanguard, though late to the game, is beginning to offer ETFs in direct competition with their flagship index mutual fund offerings.

I recently participated in a panel discussion at an ETF Conference in New York (Financial Research Associates ETF

Summit, September 2005), and found that Advisors seem to fall into one of three camps of ETF proponents:

**1. Activists/Evangelists** – Typically pure strategically oriented (i.e. fixed) asset allocators, this group tends to be anti-active management, as they do not believe that outperformance is either likely or sustainable. They have strong academic arguments, and are often fervent in their beliefs about the intellectually pure nature of indexing and passive investing. For this segment of Advisors, ETFs often provide the lowest cost solution to filling an asset bucket, and they plug up their allocation frameworks accordingly. Our problem with this group is that they often ignore the potential for greater performance or absolute return with this dogmatism (see “To Index or Compete...” Q1’05 EconomicMemo@[www.OsbornePartners.com](http://www.OsbornePartners.com)).

**2. Tactical Allocators/Market Timers** – This group tends to be less extreme in their views about pure indexing, and most have developed systems to move in and out of markets, and from market participation to avoidance (i.e. in stocks or in cash). While the preponderance of evidence would suggest that market timing has worse odds than Blackjack (yes, the card game they play in casinos) has the odds working against it, the proponents are true believers and have plenty of their own data to refute the naysayers. They utilize ETFs because these vehicles allow them to capture markets or sectors as they see fit to participate, and move in and out with lower fees and greater ease of trading than traditional mutual funds. According to one of my fellow panelists from the New York conference, “ETFs are merely tools...like stocks or bonds...” for Advisors to better serve their clients. He’s taken the extraordinary step of setting up a BLOG ([www.ETFtrends.com](http://www.ETFtrends.com)) to educate Advisors and Investors alike on these popular “tools”.

**3. Active Wealth Managers** – For firms like Osborne Partners, ETFs provide an excellent means to diversify clients into markets or allocation choices where our primary objective is risk control. By adding international or emerging market exposure to an individually managed equity portfolio, we can lower the volatility of the portfolio, and provide our clients with the opportunity to participate in other economies at a very low cost. Additionally, for our clients that have an interest in tilting their portfolio toward smaller cap stocks, or more value oriented holdings, we can utilize ETFs for this tranche, while pursuing higher tax aware returns through their individually managed holdings. In the words of Justin McNichols, one of our Portfolio Managers, “avoid the extremes” by trying to exploit the best of both camps.

In our experience, investment disciplines or philosophies are much like religions – you believe what you believe, and there’s little point in arguing the merits of one case versus

another. When properly executed, each of the above philosophies can and do work well for investors. As long as your Advisor is committed to maximizing returns, and minimizing both risk and costs, the “tools” they use and philosophy they employ are less important. In the final analysis of this topic, and somewhat in contrast to other parts of life, it’s more about the destination than the journey. As always, if we can help you sort through some of these issues, please call us at (415) 362-5637 or send an email to [Invest@OsbornePartners.com](mailto:Invest@OsbornePartners.com) with your questions. Stay tuned for Part II on Hedge Funds next quarter.

## Privacy Policy and Safeguarding Client Assets

**Pursuant to Regulation S-P regarding the protection of Client Information, OPCM is required on an annual basis to offer to our clients a copy of our Privacy Policy.**

Your relationship with Osborne Partners is of the utmost importance to our firm. We understand the importance of your privacy and security of the information relating to you and your account. As a client, it is necessary to provide personal financial information to us to ensure that your account is managed in a manner consistent with your investment objectives and personal financial goals.

It is the policy of Osborne Partners to not disclose any non-public personal information about you to any unaffiliated party while you are an active or inactive client, except as permitted or required by law.

To conduct regular business, the information we receive and collect from you will be from the following sources:

- Investment advisory contracts and custodian account applications.
- Information about your securities transactions with Osborne Partners or other advisory firms including broker/dealers who may be providing financial services for your account in conjunction with the services OPCM provides.

All information will remain strictly confidential. Osborne Partners will adhere to the privacy policies and practices as described in this notice. In addition, employees with personal information relating to your account may not disclose your account information except for business use. Our firm maintains physical, electronic, and procedural safeguards to protect your non-public personal information. If you have any questions or would like a full copy of our policy, please feel free to contact Shannon Lemon .

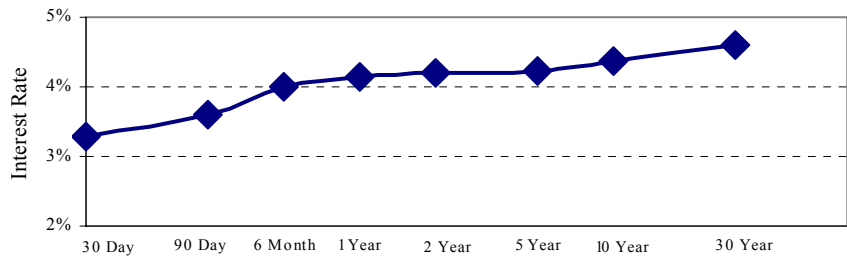
# Fixed Income Round-Up

By Robert C. Gillooly, CFA

**October 5, 2005**

|                             | <u>Yield</u> |
|-----------------------------|--------------|
| Average Money Market        | 3.00%        |
| 5 Year AAA Muni Bond        | 3.44%        |
| 5 Year AAA Corp Bond        | 4.70%        |
| 10 Year AAA Muni Bond       | 3.96%        |
| 10 Year AAA Corp Bond       | 5.09%        |
| 30 Year Fixed Rate Mortgage | 5.52%        |

## Treasury Yield Curve



As anticipated, short-term bond yields continued to rise in the third quarter of 2005.

The Federal Reserve continues to raise

short-term rates by .25% approximately every six weeks, leaving their Fed Funds lending rate at 3.75%. OPCM expects additional increases forthcoming in 2005. These frequent and methodical interest rate increases have finally pushed money market rates up past 3%, which is a long way from the paltry 1% (or less) many were offering just 2 years ago.

Near term concerns revolve around high energy prices and the worry that this will spill over and cause inflation in other areas of the economy, which argues for higher interest rates to combat this phenomenon. Yet this concern should be offset by the fear of a slowing economy, which conversely would argue for lower interest rates. Thus, OPCM does not expect a change in our outlook of a continued very gradual rise in rates.

## Transferring Wealth Through an IRA - The Importance of Beneficiary Designation

By Shannon S. Gallo-Lemon, CFP®

With IRA's representing a significant asset in many estates, careful considerations should be given to naming an IRA beneficiary, since each choice has different tax and distribution consequences.

**Spousal Beneficiaries\*** – Spouses are the most widely named beneficiaries of IRAs because account owners either do not know what else to do, or the surviving spouse may need the assets for their lifetime financial support. Naming a husband or wife has significant tax benefits as they can elect to rollover the inherited IRA into their own name, designate new beneficiaries, and postpone withdrawals until age 70 ½. This can all be accomplished without triggering estate taxes. The downside is if the spouse does not need the assets for financial support, the IRA will continue to grow in their estate and just delay or defer the estate taxes due and in the end, may result in a larger estate tax.

**“Non-Spousal Beneficiaries”\*** – Naming non-spousal beneficiaries, such as children or grandchildren, provides the opportunity to “stretch” the IRA over the beneficiary's life. The main advantage is that the “Stretch IRA” provides an annual income stream and allows the assets to continue to grow tax deferred. Disadvantages are that the distributions are considered taxable income, however, they are exempt from the 10% premature distribution penalty. Beneficiaries can take out more than their required minimum distribution, but never less.

**Trust Beneficiaries** – The most significant advantage to naming a trust as a beneficiary is the ability to control all of your assets at death, especially if you want certain individuals to receive an inheritance without having full control. Disadvantages are the surviving spouse loses the rollover opportunity; only the age of the oldest living beneficiary can be used to determine life expectancy, thus, the IRA could be depleted rapidly; and finally, if one of the trust beneficiaries is a non-individual, the entire IRA must be distributed within 5 years. Trusts also have the highest tax rates (39.6%) so if all income is not passed to the beneficiaries, the trust pays the taxes on the difference.

**Charitable Beneficiaries** – Leaving an IRA to a charity can be a big tax savings as the estate gets a charitable deduction equal to the amount of the IRA, plus the charity is not subject to income taxes when the IRA is distributed. If non-spousal beneficiaries are in high income tax brackets and do not need income, they may receive greater benefit from taxable assets that receive a step up in basis at death.

These are just some of the key considerations in naming an IRA beneficiary. The combined estate and income tax implications require careful planning and professional guidance. If you have additional questions or would like to discuss the topic further, please give me a call. *\*Special rules apply for community property states. Non-spousal beneficiaries require written Spousal consent.*