



Report From The Portfolio Manager August 2005

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Eric M. Kobren

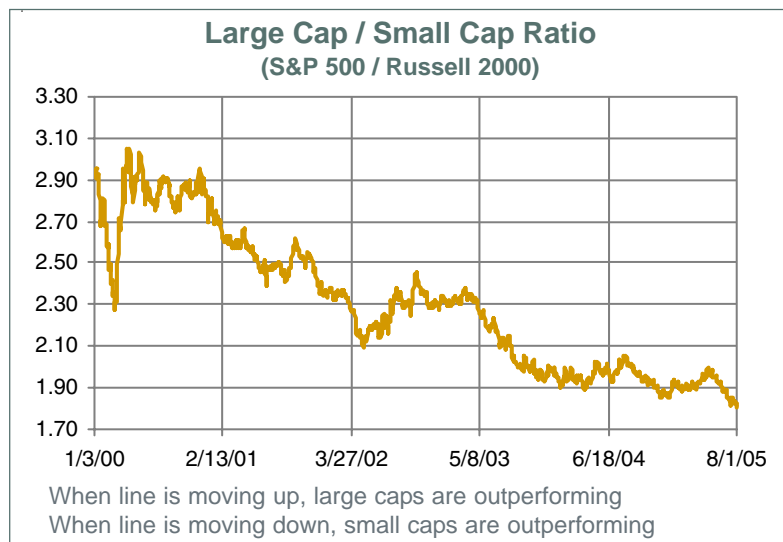
Self Examination

July was the best month of the year for the stock market, with the gains strong enough for the technology-laden Nasdaq to go into the green for its year-to-date return and for the Dow Jones Industrials to almost turn positive for 2005. The S&P 500 meanwhile, is now up 2.9% as of the end of July. Client portfolios generally performed in line with expectations, given their respective market exposures and risk characteristics.

For the most part, our tactical asset allocation moves are working this year. However, there are some areas where our positioning has detracted from our relative performance and we thought it would be useful to review those areas and give you our current thinking about them.

Small Caps vs Large Caps ■ ■ ■ ■ ■

Over the 12 months or so, we have gradually eliminated our large overweights in small and mid-sized companies and are now roughly neutral between large and small companies. The graph at right, shows how small caps have dramatically outperformed large caps for the past five years. As a result of this lengthy period of outperformance, the relative valuation picture had come to favor large caps and this was the primary reason for our moving to a neutral stance. A secondary reason was the assumption that economic growth would likely begin to slow, since a slower growing economy tends to favor larger companies.



Through the first four months of 2005, this looked like the right move as stocks of larger companies indeed gained ground on small company stocks. But since May, small caps have once again begun to outrun their larger brethren. While our relative valuation argument is still valid, to be fair, there have recently been signs of a potential re-acceleration of economic and earnings growth in the back half of the year.

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While we would question the sustainability of any re-acceleration of growth, it also seems fairly clear that the recent wave of economic data supports expansion not contraction and positive surprises, not negative surprises. We are closely monitoring the tradeoff between small and large caps and moving forward, we will, as usual, adjust our strategy if necessary.

Real Estate ■ ■ ■ ■ ■

We have carried no dedicated exposure to real estate investment trusts (REITs) in recent years (we do have some exposure to real estate in a number of underlying funds). REITs continue to be a pocket of relative strength, rising 7.5% last month alone. Our research, however, continues to show that REIT valuations are quite rich, suggesting average to below-average return potential going forward (even more so now given their appreciation this year). In addition, REITs have not been acting like REITs normally do in terms of risk characteristics. Their relative volatility remains high as do their correlations to the broad market. This means that REITs do not offer their typical diversifying characteristics which, under normal circumstances, would offer important risk reduction properties to diversified portfolios. In short, we don't like the risk/return tradeoff currently offered by REITs.

Bonds ■ ■ ■ ■ ■

Given the renewed strength in stock prices, bonds have recently relinquished their total return advantage over stocks for 2005. While we don't maintain that bonds have a higher return potential than equities over the long term, bonds still make sense for diversified portfolios. (We would, however, argue that the difference between stock and bond returns over the next decade may be narrower than what long-term averages suggest.) Not only do they provide the shock absorbers for a smoother investment experience, which is often crucial to staying with your investment plan, they can also add to returns in specific market environments. (Note: over the last 5 years, through 6/30/05, bonds were still beating stocks by nearly 10% a year!)

International ■ ■ ■ ■ ■

Despite international markets significantly outperforming the U.S. this year, at least in local currency terms, one could not tell that by looking at those same returns when denominated in U.S. dollars. Due to a stronger dollar, the Morgan Stanley EAFE Index, a proxy for developed foreign equities, was trailing the S&P 500 by 1% this year through the end of July. Nonetheless, moving forward, we remain big fans of international securities, primarily because of higher growth prospects and lower valuations. In addition, we also remain bearish on the dollar longer-term (twin deficits) and think the recent strength in the dollar was a counter-cyclical rally. All else being equal, a weaker dollar translates into higher returns for international securities (assuming the currency exposures are unhedged). In addition, international markets offer diversification as well as an expanded opportunity set for active managers to add value.



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Another “P” ■ ■ ■ ■ ■

Shifting gears a bit, when we talk about our Research Process, we often mention our “7 Ps”: Product, Price, People, Philosophy, Process, Portfolio, and Performance. We have found that list a good way to simplify the presentation of our investment approach when trying to describe what we look for in analyzing money managers and mutual funds.

Rob Arnott, who is the manager of the alternative mutual fund Pimco All Asset, as well as one of the leading academics and practitioners in the investment industry today, has yet another P: Progress.

To quote Rob: “Progress and innovation, often ignored, are actually *very* important. The nature of market inefficiencies is constantly changing. The manager who cannot or will not adapt to a changing world is doomed to steadily diminishing performance. Some investment managers proudly claim that they are using the same process they used five, ten, or fifteen years ago. Sponsors often find such a claim reassuring. They should not. It is an admission of *failure* by the manager. Such managers are admitting that for several years they have found no substantial way to refine or improve their process. They are admitting that they have found no subtle change in the way that the capital markets respond to their process.”

Committed To Improving ■ ■ ■ ■ ■

At Kobren Insight Management, we are always looking at ways to improve our process. We have added significant resources in recent years, in terms of both personnel and analytical tools. We have also pushed traditional mutual fund analysis into new areas, constantly studying and testing new ideas, to uncover more profitable ways of analyzing the markets and managers.

A partial list of our recent work includes:

- Developed a proprietary internal fund scoring methodology to add structure to our fund selection process.
- Studied the process of “mean reversion” momentum on sector funds and ETFs.
- Examined the connection between portfolio manager compensation and portfolio performance.
- Built an extensive database that allows us to examine the asset allocation of the mutual fund industry as a whole to determine whether or not we can derive valid investment signals (contrary or otherwise) from how asset “bets” are being made industry-wide.
- Created internal “Research Portfolios,” which in effect are buy lists of mutual funds. These Research Portfolios have consistently added value since we’ve introduced them.
- Developed a variety of in-house tools to monitor fund performance, as well as to manage portfolio market exposures and risk characteristics.

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We have also made strides in improving our client service and communication including conference calls, a revamped website, and a variety of articles and publications such as this *Portfolio Manager's Report*. We hope you have found them useful in understanding our investment philosophy and process.

In the end, we believe that for investment firms to be successful, they must continually grow and adapt to evolving markets, new technologies and products, and the changing needs of their clients. We will continue to ask our research team to question our process, explore new ideas and create new methodologies to improve what we do. We can always get better.

Sincerely,



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Portfolio Manager



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