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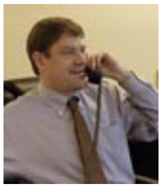

Equities in 2004: A Retrospective

I'd like to open this month's letter by throwing a spotlight on our 2004 laggards and telling you why we still like them coming into 2005.

Last year, the two worst-performing sectors in the S&P 500 were Health Care and Information Technology, and our Core Equity stocks **Pfizer and Intel**, industry bellwethers both, **fell 22.3% and 26.6%** respectively.

Autumn brought safety concerns about **Pfizer**'s Cox-2 inhibitors. Celebrex and Bextra sales are suffering, and in all likelihood, legions of plaintiffs' attorneys are gearing up to pinch company profits going forward.

Here's our take on the situation: Pfizer still has five of the 25 best-selling drugs, and it owns the leaders in fifteen different drug categories. Also, every few years it seems to be the pharmaceutical companies' turn to take a political and public relations tarring (as happened running up to the election); in the past, outraged denunciations of Big Pharma and predictions of its demise have made for buying opportunities. The demographic imperative remains: Baby Boomers will live longer and consume more drugs than their parents.

With its Cox-2 woes now reflected in its stock price, its cash flows still strong, its product portfolio robust, and its outsized dividend seemingly secure, we see long-term promise in Pfizer that outshines much else of we see in the market. The stock trades at a 10.7 forward P/E and carries a 3.0% dividend yield.

Intel stumbled after trying to maintain premium pricing in the face of price cuts by its flash memory competitors, scrapping development of its Prescott microprocessor, and losing ground to a new product from arch-nemesis AMD. Also, inventories hit uncomfortable highs, an indicator of demand vs. pricing trouble.

We see these as short-term challenges that are being overcome as Intel moves from selling on a component basis (microprocessors) to selling on a platform basis (silicon + complementary software). Altogether, this strategic reorientation makes shrewd sense, and it should strengthen the company in the years to come.

Intel remains not just a good tech company, but a great manufacturing company and great brand, and we believe its vertically integrated structure — owning its value chain from research to design to production to marketing — will give it an enduring competitive advantage. The stock trades at a 17.9 forward P/E, and after doubling its dividend last year, yields 1.3%.

For the sake of balance, I should point out that Allen Trust's Core Equity Portfolio had big winners too. In a year when the S&P 500's technology sector returned just 0.24%, **Checkpoint Software rose 46.1%**. Meanwhile, rookie Core Equity holding **KB Homes was up 42.9%** from its date of introduction to the list, and **Costco** rounded out our top three with **a 31.2% rise** for the year.

Altogether, **21 Core Equity stocks rose** in 2004, and just **3 declined**. Before dividends, the portfolio was up 10.6% (equal-weighted) vs. 9.0% for the S&P 500.

Fixed Income in 2004 (and a glimpse of 2005)

Briefly, to me the two big stories for fixed income last year were the Fed's retreat from an accommodative monetary policy — it raised rates in 0.25% increments five times starting in June — and the resilience of the bond market, which overcame expectations that inflation, foreign exchange pressures, and Fed action would push rates higher across the yield curve.

The Fed's rate hikes were expected. They're a big story nonetheless because they end an epoch when rates drifted to mind-boggling lows.

As for the bond market, pain was confined to the short end of the yield curve (i.e. short-term instruments), yet coming into 2005, it's the one area that makes sense from a risk-return perspective. Today, Treasuries with a 3-year maturity yield 3.47%, while the 10-year Treasury yields 4.08%. To me, a 0.61% premium is scant reward for taking on 7 more years of interest rate risk.

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