MJB ASSET MANAGEMENT LLC

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Dear Clients and Friends:

Investment risk often comes from events that are beyond investors' control. More importantly, and as is *always* the case in investing, every investor should remember to focus on that which they *can* control: choosing an asset allocation for their portfolio that properly reflects their individual tolerance for risk. Remember, too, that the proper allocation for your portfolio is not written in stone. The unique mix of stocks, bonds and cash that matches your financial goals and tolerance for risk can change any time your financial circumstances change and/or your feelings about risk change.

The military action in Iraq injected temporary uncertainty into consumer and corporate spending decisions. As soon as the military outcome became certain, investors pushed the markets back up to levels that reflected economic fundamentals as opposed to the uncertainty of war. And the post-war fundamentals are very similar to the pre-war fundamentals: the U.S. economy is sluggish but starting to recover in fits and starts. Consumers are still spending,[1] corporations have continued to trim their inventories and expenses and many are beginning to report improved earnings. At the same time, unemployment remains relatively high, wages are declining[2] and certain industries, such as airlines and telecommunications, remain in economic distress.

There is one significant difference in the post-war economic landscape to contend with: the $100 billion price tag that must be paid for by raising taxes, cutting government spending and/or borrowing money. The current administration opposes new taxes, leaving the money to come from cuts in government spending and/or borrowing from the public. We do not know where the spending cuts will be, but we do know the effect of borrowing roughly $100 billion: intermediate and long term interest rates will likely rise as the federal government competes with other borrowers for money.[3] Any increase in rates could place a drag on an economic recovery

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[1] This is curious in light of the relatively high unemployment rate. Much of it has to do with low interest rates, which have kept housing prices high and enabled homeowners to take equity out of their homes and spend it.

[2] "As Companies Reduce Costs, Pay is Falling Top to Bottom," *New York Times*, April 26, 2003, p. C1.

[3] Intermediate term and long term rates are determined by supply and demand for debt in the marketplace, and not by the Federal Reserve. The Fed controls short-term rates and will likely keep them low to avoid impeding any recovery.

as the costs of borrowing money to fund new projects increase. Mortgage rates could rise, leading to a slowdown in real estate activity and refinancing, which could dampen consumer spending. Add to this the economic malaise hitting many state and municipal governments. Most face yawning deficits of their own as tax revenues have declined in the economic downturn while expensive spending priorities from fatter years need to be completed. Urban areas are faring worst, as they cope with the increased cost of security in a post-9/11 world. The result will likely be layoffs, reduced services and/or increased fees and taxes at the state/local level.[4]

Thus, we see substantial economic risk remaining after this war, and we have adjusted client portfolio allocations to be more conservative. We have reduced our positions in funds that invest using "growth" strategies and replaced them with funds using "value" strategies. Growth strategies, in which investors purchase stocks that they believe will generate consistently growing earnings, are far more risky in times of economic uncertainty, when even the best-run companies have difficulty providing yearly increases in profitability. By contrast, value oriented investors buy stock at bargain prices in companies with assets and/or earning power that are undervalued, and then wait for the stock price to rebound back up to fair value. Such strategies are well suited for times of economic uncertainty, when many top quality companies fall temporarily out of favor with investors and suffer unwarranted declines in their stock prices.

We also have increased our positions in funds that follow strategies that do not correlate too closely with the movements of the stock market. One such strategy is merger arbitrage, in which an investor purchases the stock of a target company in a publicly announced merger or acquisition and "sells short"[5] the stock of the company that is making the acquisition. This technique locks in a spread between the prices of the two stocks. When the merger closes, the spread between the two stocks disappears as they become one company -- the stock of the target firm goes up and the stock of the acquiring firm goes down. Because the investor owns the stock that is going up and has shorted the stock that is going down, the fund profits on both sides of the transaction. Historically, this strategy has produced returns of 8%-12% per year, regardless of what the broad stock market does.

And we have begun to make larger allocations to bonds, including for some clients who have historically been all-equity investors. When external shocks to the market materialize, investors often flee to the relative safety of bonds, making them a hedge against the risk of geopolitical uncertainty. To guard against the earlier-mentioned potential rise in interest rates, we have purchased mostly short term and high yield bonds. Both are relatively insulated against the risk of rising interest rates – the short term bonds because their short maturities eliminate the

[4] As an example, New York City recently raised property taxes by 18%, is increasing bus and subway fares by 33% and has announced the start of municipal layoffs to help meet a multi-billion dollar deficit. As recently as two years ago, the city had a multi-billion dollar surplus.

[5] "Selling short" refers to borrowing shares of stock and selling those borrowed shares on the expectation that the price is going to decline, at which point the seller/borrower repurchases the stock at the lower price and returns the shares to the original lender (plus interest on the "loan"). Short sellers pocket the difference between the price at which they sell the borrowed stock and the lower price at which they re-purchase the shares. Short selling thereby enables an investor to make money on a stock that declines in price. (On the flip side, if the furrowed stock increases in price, the short seller must re-purchase the stock at the higher price and suffer the corresponding loss.)

risk of fluctuating interest rates and the high yield bonds because they have high coupon rates and are not hurt when rates on other bonds increase.

As always at MJB Asset Management, we invest side by side with our clients in all of the same stocks and funds. For clients with individual stocks, we continue to invest in blue chip companies trading at prices at least 40% below their highs. As their stock prices rise back toward their highs, we reduce our positions and look to invest in other stocks trading at prices of 40% off or more. This strategy served our clients well this past quarter, as our portfolio of seventeen high quality stocks outperformed the S&P 500 by roughly 2%. We believe that the market continues to substantially undervalue the businesses that we own, and we made no changes to our basic portfolio of large cap stocks this past quarter.

For clients with mutual funds, we always seek managers with a demonstrated ability to add value through a well-conceived and well-executed investment strategy. Though we are able to find such managers in a variety of investment categories, this past quarter we continued our shift toward managers who follow "value" strategies (see earlier description). Value strategies tend to be less volatile than, and have lower correlations with, the markets overall. And as also mentioned above, we have increased our positions in funds that utilize conservative hedged strategies as a guard against potential drops in the market.

Always remember that asset allocation is an extremely important element of your overall investment strategy. If your circumstances have changed or you have any questions about your allocation or any other aspect of your investment portfolio, please feel free to give us a call. We always look forward to speaking with you.

Thank you for investing with MJB Asset Management.

Sincerely,

Richard Bregman

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