

Altamont Capital Management

First Quarter 2005 Performance

“We are all like tenant farmers chopping down the fence around our house for fuel when we should be using Nature’s inexhaustible sources of energy – sun, wind, and tide. I’d put my money on the sun and solar energy. What a source of power! I hope we don’t have to wait until oil and coal run out before we tackle that.”

Thomas Alva Edison (1910)

The first quarter saw mostly red ink in the financial markets with both stocks and bonds experiencing losses. The S&P 500 index iShares declined 2.8% during the first three months, while the Vanguard Total Bond Market Index Fund (this is a good proxy for the overall bond market) dropped 0.5%. It is atypical when both stocks and bond decline in a quarter. Also unusual, mid-caps outperformed both larger- and smaller-cap stocks. Small-caps fared poorly, with the S&P 600 iShares (iShares are exchange traded fund that trades like a stock and owns the shares in the index) dropping 2.4% for the year through March, while the S&P 400 iShares (representing mid caps) were down only 0.8%. Among other asset classes, foreign bonds dropped about 2.6% in the first quarter, due to the dollar retracing some of its losses.

The First Quarter partially retraced the robust gains generated in the Fourth Quarter. The graph below illustrates how robust the Fourth Quarter 2004 returns (the first bar) were for every category compared to the First Quarter 2005 (the second bar). Most of the equity gains for 2004 were generated in one big lunge upwards during the Fourth Quarter. After such substantial gains, it is not unusual to give some of it back the next quarter.

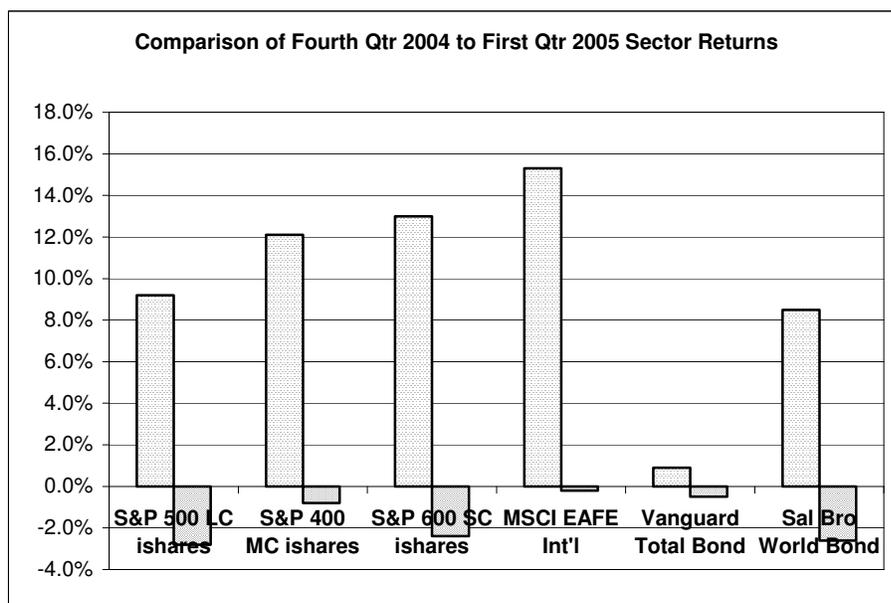
During the last year, there has been no shortage of uncertainty.

Concerns about sharply rising oil prices and overall inflation, rising interest rates, and risk to the dollar from our massive current-account deficit have all weighed on the markets.

While markets have reacted and sometimes overreacted to short-term news, there have not been any gross mis-valuations in the overall equity or bond markets. Still, it is only a matter of time before the inevitable forces of fear and greed create valuation excesses in one direction or another. It is

impossible to know when or how the next opportunity will show up. Often it results from a surprise event, and sometimes it’s just a slow grind: an asset class moves in one direction and finally gets to the point where it is either cheap or expensive. While there are no great tactical return opportunities now, I continue to research a wide range of asset classes. This will enable us to quickly identify and act on the next good opportunity.

I added some defensive tactical allocations in most clients’ portfolios during the last quarter. The addition of Commodity Futures and Secured Floating Rate Bonds essentially amount to “free insurance.” In both cases, the goal is to protect your portfolios from specific (or general) risks without compromising return potential in most



scenarios. These are defensive play that have at least a decent chance of even adding a little bit of extra return in a normal market. Furthermore, these defensive plays should benefit the portfolios even under other scenarios, some of which are negative. These moves will not add significant additional returns to your portfolio, but amount to free insurance, or better yet, you might get paid for taking that insurance.

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Then came the Witch’s voice, cooing softly like the voice of a wood-pigeon from the high elms in an old garden at three o’clock in the middle of a sleepy, summer afternoon; and it said “What is the sun that you all speak of? Do you mean anything by that word?”

“Yes, we jolly well do,” said Scrubb [one of the children].

“Your sun is a dream...”Slowly and gravely the Witch repeated, “There is no sun.” And they all said nothing. She repeated, in a softer and deeper voice, “There is no sun.” After a pause, and after a struggle in their minds, all four of them said together, “You are right. There is no sun.” It was such a relief to give in and say it.

C. S. Lewis from the Silver Chair Novel of Chronicles of Narnia

I decided last year to re-read a few of my favorite books from childhood. I love the Chronicles of Narnia. As I was reading The Silver Chair, this passage struck me as a perfect metaphor for herd mentality (the old following the crowd problem) that plagues many investors. For instance, in the final stages of a bull market, investors hear from their friends, brokers and the guy who cuts their lawn, “There is no risk. The market only goes up. A limitless fortune awaits you.” In the book our heroes manage to fight off the enchantment, but in real life how many investors succumb?

For a current example, look at the housing market. It feels like the end of a late bull market bubble to me. I have people in the supermarket, at work, and at my coffee shop telling me that you can’t lose money in the rental housing market. They say, “It’s a sure thing.” We all know intuitively that there is no such thing as a sure bet in life. I’ll discuss the housing market in more detail towards the end of this newsletter.

During the quarter, most asset classes experienced losses due in large part to a growing awareness of inflation risks. Interest rates are rising, the dollar has been declining, and the price of oil has been surging. The Large and Small Cap stocks took the worst of the decline while Mid Cap stocks held steady. Value stocks declined more than Growth. This was true for market cap sizes (Large, Mid and Small).

Bonds were also negative this quarter reflecting the impact of rising interest rates. The Federal Reserve will continue to raise interest rates through the rest of the year, making it difficult for bonds to post positive earnings.

I never expect all of the funds in your plan to beat their benchmarks at the same time; there will almost always be a few that are under performing at any given moment. This could be due to many factors: poor performance by a handful of large stock holdings, contrarian bets, subtle stylistic differences between the fund and its benchmark, etc. Over the long-term, however, I expect them to beat their benchmarks *on average*.

| First Quarter 2005 and Twelve Month Benchmark Returns | | |
|---|---------------|--------------------|
| | First Quarter | Last Twelve Months |
| Large-Cap Benchmarks | | |
| S&P 500 iShares | -2.8% | 6.0% |
| S&P 500 Growth iShares | -2.3% | 3.5% |
| S&P 500 Value iShares | -3.2% | 8.3% |
| Mid-Cap Benchmarks | | |
| S&P 400 Midcap iShares | -0.8% | 9.9% |
| S&P 400 Midcap Growth iShares | -0.4% | 8.4% |
| S&P 400 Midcap Value iShares | -1.2% | 11.2% |
| Small-Cap Benchmarks | | |
| S&P 600 iShares | -2.4% | 12.9% |
| S&P 600 Growth iShares | -1.9% | 12.9% |
| S&P 600 Value iShares | -2.8% | 12.2% |
| Other Benchmarks | | |
| MSCI EAFE Int’l iShares | -0.2% | 14.7% |
| Vanguard Total Bond Mkt Index | -0.5% | 1.0% |
| Sal Bro World Govt Bond Index | -1.3% | 5.6% |

Asset Allocation Update: Defensive Tactics

Earlier this quarter, I added a position in commodity futures to almost everyone's portfolio using the PIMCO Commodity Real Return Strategy Fund Institutional shares (PCRIX). This is a defensive play aimed at bolstering your portfolio if the stock and bond markets have a depressed period of performance.

Why Commodity futures? Commodity future indexes have posted strong long-term returns that have a low correlation to stocks and bonds. In particular, commodity futures have historically had strong performance during periods when both stocks and bonds have done poorly.

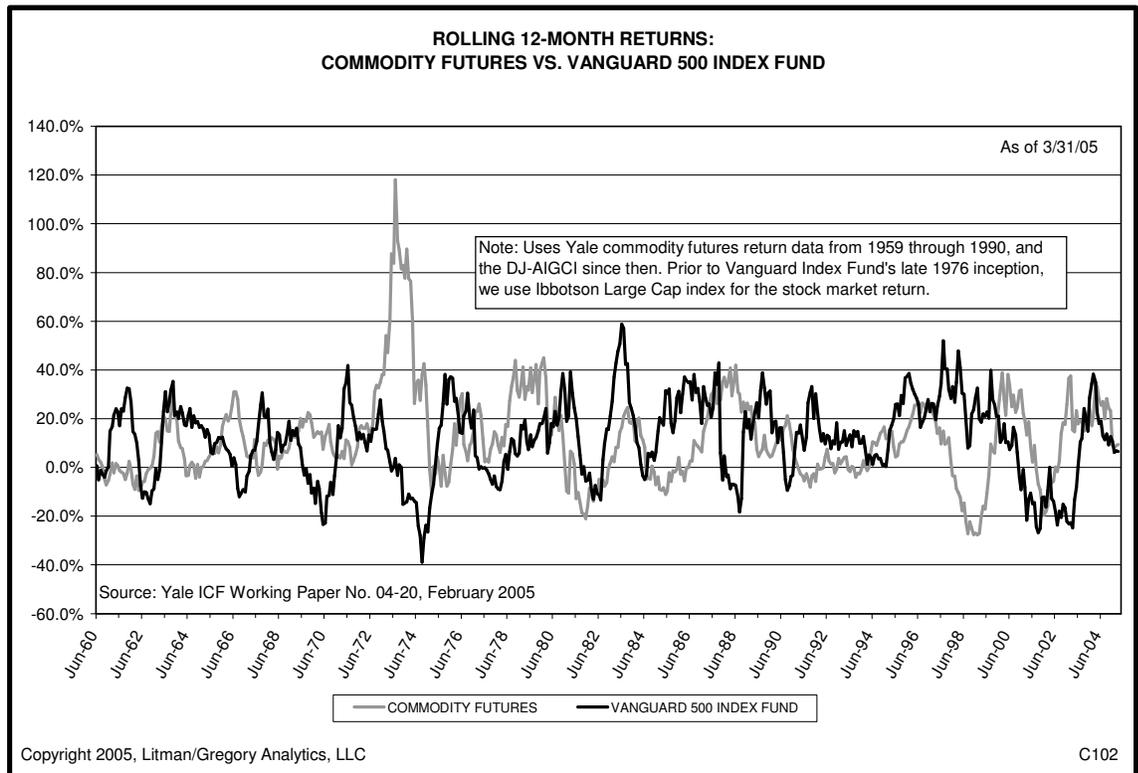
Commodity futures generate return in several ways. First, the futures contracts guarantee a set price at a future date, and commodity producers pay what can be thought of as an insurance premium for that certainty. In essence this can be thought of as compensation for providing insurance to commodity producers who want to hedge their exposure to fluctuations in commodity prices. This insurance is largely independent of changes in commodity prices, so even if prices decline commodity futures can generate a positive return.

Second, the collateral that backs futures contracts is invested and earns a return. It only takes a small amount of the capital to buy the futures contracts. The rest is the collateral. In PIMCO a small percentage of the assets are used to purchase commodity swaps that are designed to replicate the performance of the Dow Jones-AIG Commodity Index (DJ-AIGCI). The remaining assets serve as collateral and are invested in portfolios of Treasury Inflation Protected Securities (TIPS). These treasuries will probably generate returns in the low to mid single digits. This return can be added to the other return components.

Third, individual commodities are uncorrelated to one another, and as a commodity futures index is rebalanced a return is generated over time from reversion to the mean. This happens as strong-performing, over weighted commodities are reduced and weak-performing, underweighted commodities are added. This benefit can only be captured if the index is owned over many years.

All of this is in addition to any returns that would come from price changes in commodities that are different than what the market was expecting—i.e., if actual commodity prices ended up being much higher than what investors were expecting, those future contracts would appreciate in price. That's what makes commodity futures a good hedge against inflation.

It is these changes in expectation (in price) that have the most impact on the index's price movements in the short term. A 12-month futures contract price reflects the market's current expectations about what the price of the commodity will be 12 months from now. Here is a simplified example; Assume the current (spot) price of oil is \$35/bbl (per barrel). The futures contract



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expires in February 2006 might be priced at \$25/bbl, i.e., the market is forecasting that the price of oil will drop by \$10/bbl over the next 12 months. So, if the price of oil only declines to \$27/bbl next February, you will still make money owning the futures contract, even though oil prices dropped \$8/bbl. As long as the decline in the price of oil is less than what the futures market was discounting you will earn a positive return on the transaction. On the other hand, if the futures market is pricing an increase of, \$5/bbl over the next 12 months, but the price only rises \$3/bbl, your return from that futures position will be negative since your contract commits you to paying the higher price. Expectations can be volatile over relatively short periods, so it should be no surprise that the volatility of the commodity futures indexes are generally on par with the stock market though they tend not to be volatile at the same time.

Commodity futures have some very attractive diversification characteristics that are beneficial to balanced portfolios: they often do well when stocks and bonds are doing poorly, many major macro-level crises are positive for prices of certain commodities, and their lack of correlation adds a nice level of risk control without having to sacrifice return potential.

Commodity futures have been on a roll lately, raising the possibility of a near-term pullback. But since initiating the position, performance has been strong (highlighting the dangers of trying to be too precise in timing your purchases) and at current levels the investment still makes sense from a long-term standpoint.

The second defensive play this quarter was to change the composition of your bond holdings to partially protect against rising interest rates. As interest rates rise bonds fall in value. When the decline in the value of a bond is greater than the interest received bonds are generating a negative return. Since we are in a rising interest rate climate it is safe to assume that bonds will not be generating extraordinary returns in the next few years and may very well fall in value. Why not sell the bonds now? Well, bonds provide a valuable role because they behave differently than stocks over the long run (just like commodity futures). For instance, if we had a terrorist attack stocks would probably fall in value and bonds would rise.

To keep your bond exposure but minimize the negative impacts of rising interest rates, the Eaton Vance Institutional Senior Floating Rate Fund was added to most portfolios. Senior floating rate loans are loans made by U.S. Banks and other financial institutions to large corporations. Floating rate funds are less susceptible to interest rate risk than fixed rate bonds because rates are periodically reset to the prevailing interest rate. So if interest rates increase slowly this fund is less apt to generate a negative return. Year-to-date the fund has generated a 1% return versus the negative 0.5% return generated by the Vanguard Total Bond Index.

These loans are the senior source of capital in a borrower's capital structure (they are first in line if the company goes bankrupt) and have some of the borrower's assets (real estate, machinery, investments) pledged as collateral. So if the borrower defaults on the loan the assets become the property of the mutual fund. The value of the collateral may not offset the full value of the loan but the Eaton Vance fund has tried to minimize the risk of default by monitoring creditworthiness of the borrowers carefully and spreading risk by investing the fund in over 450 separate loans. Rarely does a loan represent more than 1% of the fund's assets. As of March 31, 2005 only five out of the fund's 466 loans represented more than 1% of the fund's investments, with the largest loan representing a mere 1.4%. This broad diversification helps to minimize the impact of default. The addition of this fund should add additional returns while further diversifying your portfolio.

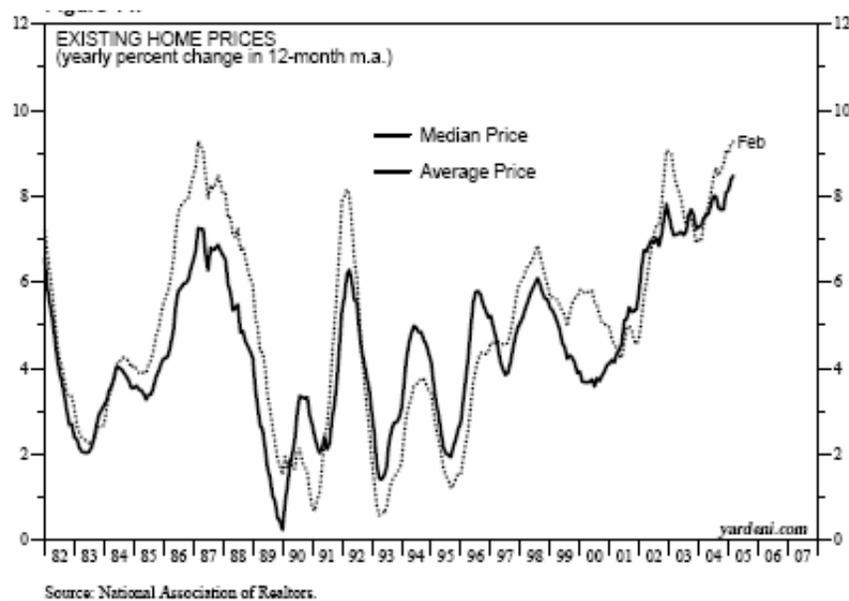
My thoughts going forward

In the base-case scenario, both U.S and foreign equities are expected to generate returns in the high single digits on average over the next five years (returns could vary widely in individual years).

On the positive side, though earnings are slowing they are still likely to be in the high single digits. And while interest rates are moving higher, it is quite possible that they will remain low enough to be fairly accommodative. Another positive trend that I've previously discussed is the relatively cash-rich state of corporate balance sheets. The wish is that these large corporations will begin to increase their capital spending, boosting the economy and offsetting any decline in consumer spending.

I am not too worried that the economy will experience a *major* permanent uptick in inflation over the **long term** (longer than three years). The economy will experience some inflationary pressure but it may be short lived. The reason; Debt levels are high enough that an inflation-induced increase in interest rates would create higher debt servicing costs, which in turn could have a disinflationary (or even deflationary) effect on the economy. O.K., in English – Consumers have a tremendous amount of debt (specifically credit card debt) and as interest rates rise the cost of paying for this debt increases, leaving less money to spend on new items and discouraging consumers from taking on new debt. If consumers buy less goods there is less competition for goods (demand is not greater than supply) so there is no shortage of goods - the result sellers have to offer incentives to move goods (no pricing pressure). In fact, prices may have to fall to induce consumers to spend money. That is a disinflationary economy – lack of inflation to slight negative inflation.

The Federal Reserve will keep raising short-term interest rates but not because they are worried about broad-



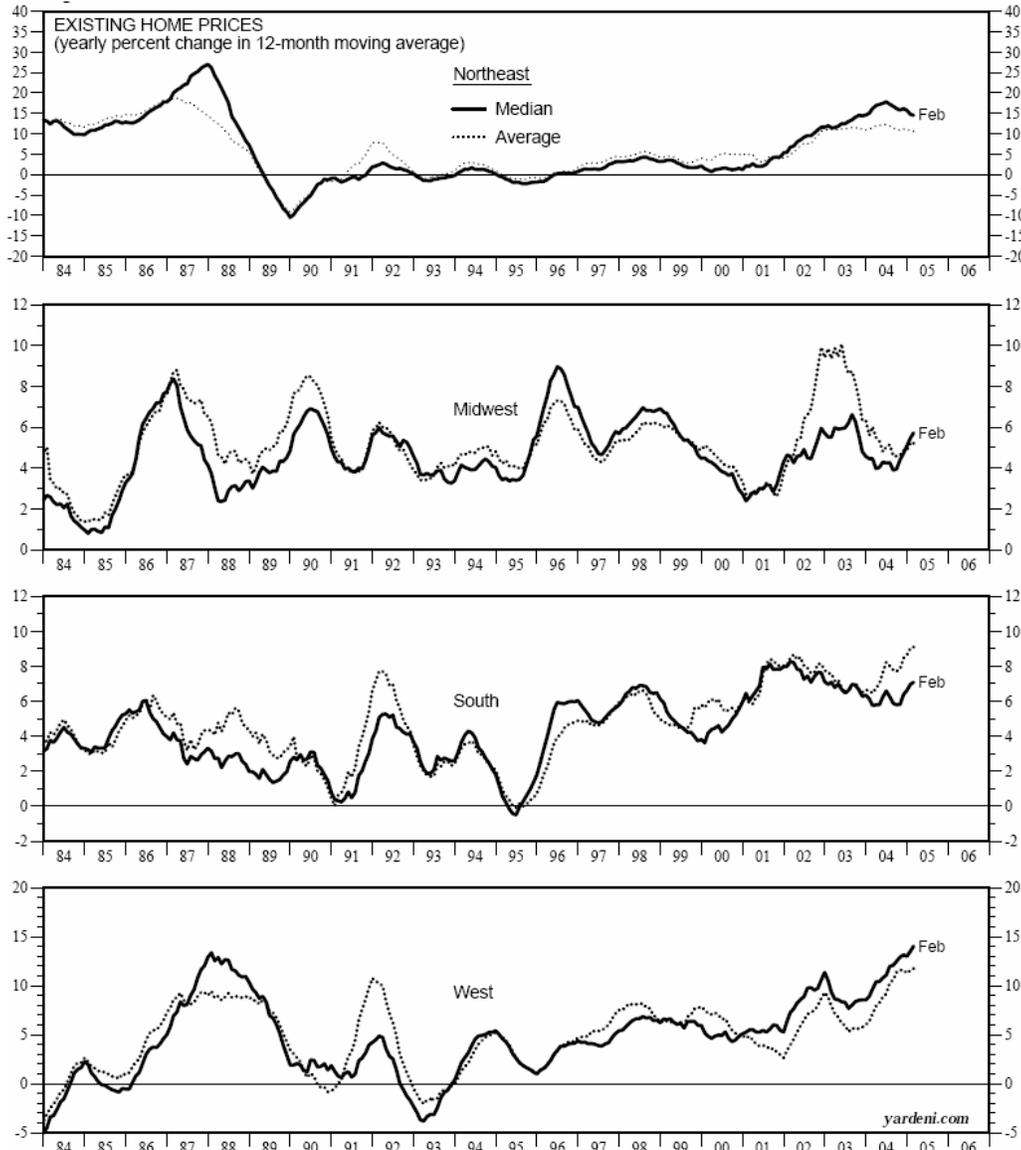
based inflation. The Fed is concerned about another speculative bubble, this time it's real estate instead of stocks. I believe the Fed is becoming alarmed about the rapid rise in housing prices. In February, the median existing home price rose to \$188,200, up 8.5% from a year ago using a 12-month moving average and 25% over the past three years. The one-year rate of appreciation (for the last 12-months – 8.5%) now exceeds all previous cyclical peaks since 1982. Of the country's four regions, the Northeast and the West stand out as the most speculative and the most prone to painful adjustment. In the West, the median existing home existing is up

14% in February (from the previous February), exceeding the previous cyclical peak of 13.4% (annual rate) during January 1988. In most of the country, the housing market remains rational with values appropriate relative to incomes and mortgage terms. There are certainly pockets of speculative excess especially in California. I am not sure when this speculative bubble will burst. Usually when everyone acknowledges that there is a bubble that could burst any moment, the bubble gets even bigger before it finally pops. For instance, the cover story of The Sunday New York Times real estate section on March 27 was "What Happens If It Bursts?"

So the Fed is trying to talk long-term interest rates up to drive mortgage rates up. Remember, the Fed can only impact short-term rates. The bond market sets long-term rates. Why doesn't the Fed just raise the short-term rate quickly upwards instead of this measured pace of 25 basis points (0.25%) per meeting in order to tighten up credit? There could be unintended consequences. A sharp change might burst the housing bubble and send the

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economy into recession. A sharp rise in interest rates would increase the cost of buying a new home, thereby reducing demand. The demand shortage leads to an oversupply of houses up for sale. Many sellers would then be forced to either lower their asking prices or pull their homes off the market. The concern of this market cycle



is the increased number of speculative buyers that have purchased homes in the most speculative markets.

Hot markets like Las Vegas have seen a substantial increase in activity by speculators. If speculators (investors who have purchased homes as hot investments and not residences) succeed in driving prices too high in a particular market, the chances are high that home prices will at some point tumble.

Usually housing corrections are modest with prices first leveling off for a while and maybe a minor decline. An extreme case would be the Bay Area housing correction of 1990 when housing prices fell over 15% after a long run up. Less volatile areas saw prices just level off.

Why is the Fed worried about a housing bubble? Greenspan doesn't want to pop the bubble and push the economy into a consumer-led recession at the end of his tenure.

In his February 16th testimony, he acknowledges that rising home prices have boosted consumer spending and economic growth:

“The rapid rise in home prices over the past several years has provided households with considerable capital gains. Moreover, a significant increase in the rate of single-family home turnover has meant that many consumers have been able to realize gains from the sale of their homes. To be sure, such capital gains, largely realized through an increase in mortgage debt on the home, do not increase the pool of national savings available to finance new capital investment. But from the perspective of an individual household, cash realized from capital gains has the same spending power as cash from any other source.”

If housing prices fall homeowners will feel poorer and they will spend less, leading to a possible recession. Slowly taking the excess hot air out of the housing market by slowly raising interest rates is a priority for the Fed

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in order to avoid a recession. They will use any psychological tools they can to achieve their goal, like inferring in their published notes that inflation could be a problem.

So what could go wrong?

Except for the soaring price of a barrel of crude oil, all is mostly well with the world. Actually, the soaring price of oil confirms that all may be too well. The price is rising because Asia (especially China and India) and Europe are demanding oil. Many economists are calling this the Global Synchronized Boom (GSB). It is driving the demand higher and faster than most oil analysts expected. There is no shortage of oil; you can buy gasoline at any gas station whenever you wish. So higher prices are pushing up supply but not quite fast enough to keep pace with demand. The result is higher prices and the concern is rising prices could depress the world economies, slowing the rate of growth and possibly causing a recession.

Higher oil prices act like a tax on the economy. This oil tax will cause inflation which over time can translate into other serious economic impacts. Will supply ever catch up with growing demand so oil prices will not climb further? It looks like that might already be happening and that the global oil demand growth rate is peaking and beginning to fall, so the rate of increase that oil prices have been experiencing should soon stabilize and begin to fall.

It is important to recognize which fundamental factors could negatively impact the global economy and would alter return expectations. Some of these risks include higher oil prices, changes in accounting rules, increased pricing pressure from overseas competitors, rising health-care costs, etc. These impacts could lead to lower-than-expected profit margins and earnings growth. On a macro level risks (like a dollar crash, a debt crisis, unexpected inflation, a large-scale terrorist attack, etc.) could result in big short-term moves in the equity markets, but more materially could impact the average return over a multi-year horizon. Longer term there is also the risk that interest rates will move to levels that are high enough to negatively impact multiples.

In Summary

I suspect the market is grappling with pricing in some of these bigger risks. At this moment in time, it is increasing the overall level of risk and adding volatility. These forces could result in excess valuations in either direction. Fear and greed are always creating opportunities. I will keep monitoring the markets for opportunities as they come available. In the meantime I'll keep trying to minimize risk while eeking out the best returns I can.

A quick reminder: Remember, you can now contribute up to \$14,000 in your 401(k) or 403(b) in 2005. If you are over age 50 you can contribute another \$4,000 for a total of \$18,000. You can put this much in your 401(k) as long as you earn over \$14,000 if you are under age 50 and \$18,000 if you are over age 50.

A Little Housekeeping: Have you had any big changes in your household (a new child, marriage/divorce)? If so you may need to change all the beneficiaries on your IRAs and 401(k)/403(b)s. It is your beneficiaries that inherit your retirement accounts, not what your will or trust may say. Don't leave your inheritors with a mess. Please let us know if we need to update your beneficiaries.

Terri Schiavo Fallout: This case was painful for Terri's family. In order to avoid this situation, I strongly encourage everyone to have (at the very least) a will, power of attorney and a health care directive drawn up for yourself. If you already have an estate plan you could be in great shape as long as nothing has changed in your family or financial situation and it is less than 3 years old. It is important that your documents are reviewed every three years because the laws keep changing.

Please let us know if we can help you with any of these issues.

Libby Mihalka