

Altamont Capital Management

Fourth Quarter 2004 Performance

“All mutual fund organizations work from the principle that investors flock to better-performing mutual funds – even though financial researchers have shown that the “hot” funds in one time period are often the poorest performers in another.”

David Dreman (1998)

Wow! Finally, we have broken out of the trading range in which we spent most of 2004. Stocks finished the year with a strong Fourth Quarter, bringing the full-year gain to a healthy 10.8% for the S&P 500. Small-caps did even better, gaining slightly more than 18% this year. Comparing value and growth, value held a big edge, with the Russell 3000 Value index gaining almost 17%, while the Russell 3000 Growth index was up just 7%. Foreign stocks, measured in dollar terms, also had a great year, increasing by roughly 21%.

Investment-grade bonds, despite starting the year somewhat overvalued, managed a decent year, with the Lehman Aggregate Bond Index up about 4.3%. Considering almost everyone expected bonds to perform poorly, this was a great showing. The bond market turned precedent on its head last year, when in spite of the Federal Reserve raising rates, the bond market didn't decline, it thrived. Remember rising interest rates typically cause bonds to fall in value. The Federal Reserve began raising rates in June and raised the short-term rate five times last year. Usually rising short-term rates force long-term rates up as well, but this time long-term rates remained stable.

Things Felt Different Two Years Ago

In looking back on a good year, it is worth remembering back to early 2003 when even a decent year for the markets seemed to be wishful thinking. At that time we were exiting off the most dismal year of the three-year bear market, and sentiment was extremely poor. Stocks continued to decline ahead of the Iraq invasion, the economic recovery had yet to gain traction, fears of deflation were starting to take root, and terrorism risk was on the front of investors' minds. Amidst this backdrop, the emotional reaction was to get defensive. But the rational reaction was to look at valuations and recognize that the market was already pricing in what seemed to be an unreasonably high level of risk.

Some of the same big-picture risks from that time continue to impact our thinking today. The structural imbalances in the economy are now among our biggest worries. In particular, the potential of a dollar collapse, and the impact it would have on the rest of the economy, remains a substantial risk. While I don't think the chances of a dollar collapse are high, the impact would be broadly negative across the world economy. A declining dollar could mean higher interest rates are required to attract the capital to fund our current account deficit. With many consumers already facing high household debt levels, including a lot of variable-rate debt, higher rates could depress spending as consumers lose disposable income to higher debt payments and try to rebuild their balance sheets. It could also take the wind out of the housing market—reducing another positive influence on consumer spending.

This brings us to another concern that factored into my thinking 18 months ago: deflation. The impact of a significant rise in interest rates would likely lead to a falloff in consumer and corporate spending and could result in a debt crisis, which could tip the economy into recession and even deflation. A debt-crisis or dollar-crash scenario would not be great for bonds in general, but stocks would probably do far worse, so bonds would play an important role in reducing losses at the portfolio level.

I don't mean to paint a depressing scenario for the New Year. What I want to do is remind investors that following a good year, or in this case two good years, it is easy to feel good about the markets and ignore the risks. And following a bad year, or three-plus bad years as in early 2003, it is easy to overplay the risks (even as cheap valuations provided a big cushion).

This inverted perception of risk and reward is what underlies the bulk of the decision errors made by investors. I hope that I enable you to ignore the psychological impact of recent market performance and focusing on the fundamentals, both negative and positive, of which there are plenty of positives or offsetting factors as well. For example, the economy is generally healthy, with global economic growth near a 30-year high. Productivity growth has been a positive. The U.S. consumer may not be in as bad shape as many think: credit card delinquencies have declined, and household assets have risen thanks to strong home prices. Corporate earnings have been very strong, and most corporations have plenty

of cash on their balance sheets, which bodes well for capital spending. Valuations aren't as good as they were, but they aren't horrible. So where does that leave us going forward? With few clear investment trends the key to managing your retirement portfolio will be diversification. Don't bet the farm on only a few stocks (bonds) or on one sector of the market. Prudent allocation is the key to 2005.

Fourth Quarter Performance

“Ideas are easy; it's execution that's hard.”

Jeff Bezos (Amazon.com)

Stocks performed well in the Fourth Quarter after a rocky start. In fact, most of last year's gains came the weeks after October 25, as stocks shook off their worries and staged a sharp year-end rally. Many brokers call this a Santa Claus rally. The full-year gain for the S&P 500 came in at a healthy 10.8%. Small-caps did even better, gaining slightly more than 22%. This surprised me and most of the market pundits, who expected Large Caps to outperform Small Caps. (This is why it is not a good idea to make huge market timing moves; if your timing is off, you could miss some nice gains, or worse, experience some nasty losses).

There is growing sentiment in the market that Small Caps will under perform their Mid Cap and Large Cap brethren over the next year. Small caps have outperformed large caps by a huge margin over the last several years, and the result is that they are now approaching the upper end of a fair-value range. The chart, at the top of the next page, captures the relationship between Small Cap and Large Cap valuations. Based on this analysis Small Caps are slightly over valued compared with Large Cap stocks.

Large Cap stocks yielded high single digit returns in the Fourth Quarter. Without the Fourth Quarter, the S&P 500 Index would have been at close to breakeven for the year.

Comparing value and growth for the quarter, value held a big edge with the S&P 500 Value index gaining almost 15.5%, while the S&P 500 Growth index was up just 8.4%. Value outperformed growth in the other sectors of the market for the year. The S&P 600 Small Cap Value index generated a 23% return versus its Growth brethren, which yielded a still strong 21.6% return.

International stocks did particularly well, with the MSCI International index up 15.3% for the quarter and 20.2% for the year. The fall of the U.S. dollar against most currency enhanced the performance of international stocks and bonds. I have always been an advocate for investing overseas because of the diversification benefits to portfolios. In other words, U.S. stocks have not traditionally performed in lock step with international markets. However, the U.S. and global markets have been moving more in tandem the last few years and many investment professionals are debating the merits of investing overseas. I would have to agree this is true with Large Cap International stocks but Mid and Small Cap International stocks continue to offer significant diversification benefits. Over the last few years, we have been adding Small and Medium Cap holdings to your international portfolios and will continue to add to these positions.

Fourth Quarter and 2004 Benchmark Returns		
	Fourth Quarter	Year-to-Date 2004
Large-Cap Benchmarks		
S&P 500 iShares	9.2%	10.8%
S&P 500 Growth iShares	8.4%	5.9%
S&P 500 Value iShares	15.5%	9.9%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	12.1%	16.3%
S&P 400 Midcap Growth iShares	11.9%	13.7%
S&P 400 Midcap Value iShares	12.2%	18.7%
Small-Cap Benchmarks		
S&P 600 iShares	13.0%	22.5%
S&P 600 Growth iShares	13.8%	21.6%
S&P 600 Value iShares	12.0%	23.0%
Other Benchmarks		
MSCI EAFE Int'l iShares	15.3%	20.2%
Vanguard Total Bond Mkt Index	0.9%	4.2%
Sal Bro World Govt Bond Index	8.5%	10.4%

ACM Fourth Quarter 2004 Report

Government Bonds barely broke even in the Fourth Quarter. In other words, the interest earned by the bonds offset declining bond values. Intermediate Government Bond values began to fall during the quarter as interest rates continued to rise in response to the Federal Reserve raising the short term Fed Funds rate. U.S. Corporate Bond Market barely broke even on the quarter but had a decent year yielding a 4.2% return. The performance of bonds in the next twelve months will probably be breakeven to negative.

High-yield bonds (junk bonds or low creditworthy bonds) performed very well in 2004, gaining almost 11%.

However the valuation of high yield bonds is probably too high, given

junk bonds' low spreads over investment-grade bonds. The spreads are even getting narrower now than they were at year end, and the absolute level of yields (dividends or interest paid to principal investment) is at an all-time low. This would lead the prudent investor to be wary and not chase after hot investment returns.

My thoughts going forward

“It is for these reasons of human nature, even more than by calculation of financial gain or loss, that we favor some kind of mechanical method for varying the proportion of bonds to stocks in the investor’s portfolio. The chief advantage, perhaps, is that such a formula will give him something to do. As the market advances he will from time to time make sales out of his stock holdings, putting the proceeds into bonds; as it declines he will reverse the procedure. These activities will provide some outlet for his otherwise too-pent-up energies. If he is the right kind of investor he will take added satisfaction from the thought that his operations are exactly opposite from those of the crowd.”

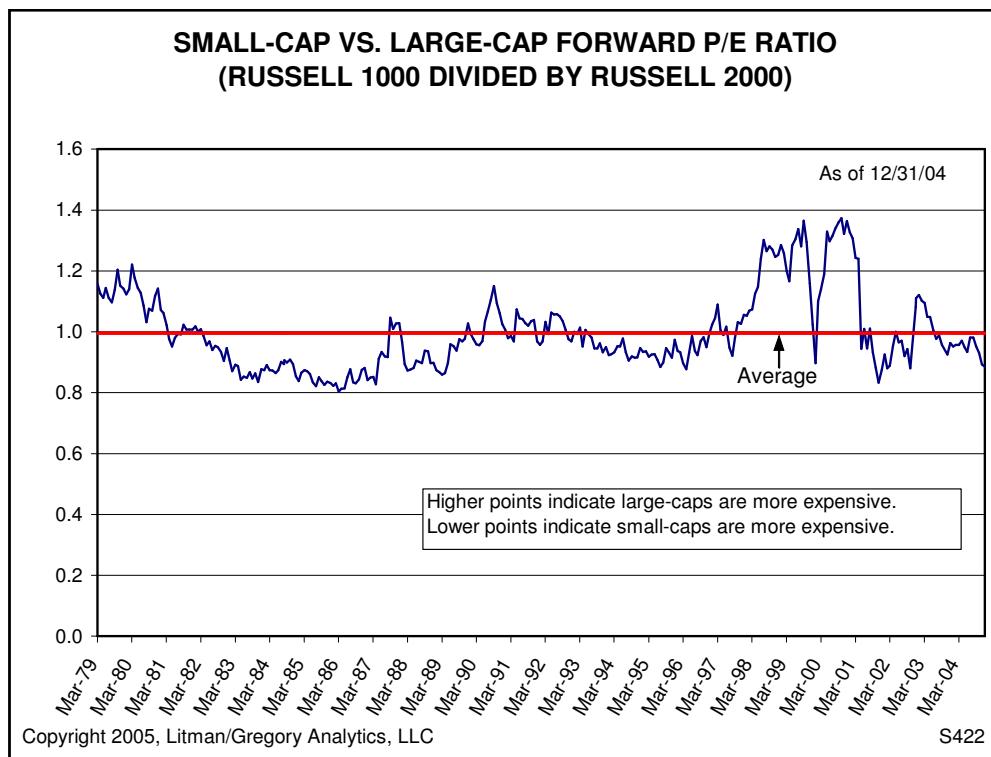
Benjamin Graham

Benjamin Graham’s book “The Intelligent Investor” is one of the bibles of investing. If you haven’t read it I highly recommend borrowing a copy from the Library. His advice is timeless and practical. In the above quote, Graham recommends annual rebalancing of investment accounts.

Overall, equities (stocks) are fairly priced right now. Fairly valued equities suggest that the margin of safety is no better than average and that stock-market investors are not placing a high probability on the troubling structural-imbalance risks. I am concerned enough about the structural imbalances that I would not overweight equity-type securities versus bonds, even though bonds are somewhat overvalued. However, it is very possible this could be a fairly benign economic-market cycle and that stocks will return strong single digit returns. Probabilities are hard to accurately assess, but the market scenario that has a fairly supportive inflation/interest-rate environment and continued gradual growth is probably the most likely outcome. This view of a benign cycle is supported by current conditions: healthy levels of cash on corporate balance sheets, muted inflation, and solid consumer spending.

Unexpectedly high inflation and deflation are both risks, with the economy currently balanced between both scenarios. Neither of these alternatives is positive for stocks, but bonds would do well in a deflation scenario. So despite the probability of rising rates, we continue to hold some bonds in balanced accounts as a deflation hedge and as protection against other events (terrorist attack within the U.S.) that could result in big losses for equities. This insurance policy is important to managing overall portfolio risk.

I have been researching commodities for more than a year and will be including them to reduce risk in most portfolios. Historically, commodities have generated very strong returns during periods when stocks and bonds performed poorly.



ACM Fourth Quarter 2004 Report

There is, of course, no guarantee that this will always be the case, but stocks and bonds typically perform poorly when inflation (expectations) and interest rates move higher, whereas commodities typically generate positive returns in such an environment. Our expectation is that a commodity futures index can generate mid-upper single digit total returns over a three to five year period. Commodities futures can be quite volatile and have significant downside risk over the short-term. For example, if there is a renewed fear of a hard landing of the Chinese economy, as happened in the spring of 2004, commodities could drop 5-10% in a month. It is the risk of a deflationary shock that could cause commodities (and stocks) to fall. Even if no economic shocks occur commodities can still fall in value, since short-term futures prices are also driven by speculative money flows, momentum and sentiment.

I will propose taking some of the allocation from equities and some from bonds in order to give you some commodities exposure. My proposed allocation will not exceed 5%. This investment should improve the overall portfolio's risk/reward profile, while hopefully not exposing you to too much risk, and should help stabilize your portfolio given the current market conditions.

One risk I haven't discussed in the past is the growing prevalence of hedge funds. By some estimates, the total asset value of hedge funds (fully leveraged) is roughly \$2 trillion. As a frame of reference, the combined market value of the NYSE and Nasdaq (these are the two largest exchanges in America) at the end of the Third Quarter was approximately \$15.6 trillion. Hedge funds are big players in the markets.

Hedge funds have been until recently unregulated. Your plumber could start a hedge fund and have only minimal regulatory hurdles to jump through. These funds use complicated hedging techniques usually involving future contracts. They are great way to make a lot of money fast or lose everything. They are usually also highly leveraged (that means the fund borrows money). In other words, a fund with \$200,000 in capital to invest will borrow \$1 million using the initial funds as collateral. Though the fund only has \$200,000, it looks as though it has a million dollars. It doesn't take much of a market move against the fund's investment strategy to bankrupt a hedge fund. An unexpected market move could cause this house of cards to fall.

Many of the fund managers I've talked to have remarked that hedge funds have indeed become very influential in the markets and are having a growing impact on price movements at both the individual stock and broad asset-class levels. And because many hedge funds utilize leverage, they are highly sensitive to market movements. This heightened sensitivity can cause them to respond more quickly and more severely to relatively small changes in the markets, which in turn can magnify the degree of the move (a "snowball effect," if you will). So going forward, it is possible that we could see higher levels of volatility when certain asset classes are at "inflection points" or are "in transition" from being in favor to being out of favor.

The good news is that a market dislocation amplified by hedge funds would cause investment opportunities in the future. The world will always be a volatile place, and at some point something will cause investors to act irrationally. Staying level headed and buying in the face of pessimism has always been a winning long-term strategy. In the mean time, it pays to be patient since the economic environment seems benign.

Financial Planning Issues

It's a new year and there are new rules and new limits. 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.

IRA contributions have increased to \$4,000 this year and will remain the same next year.. If you are over age 50, the IRA contributions are \$4,500 for this year and \$5,000 next year. There are income limitations for contributing to an IRA. If you are not covered by an employer plan and are filing Married Filing Jointly (MFJ) on your income taxes, you can contribute the maximum to your IRA as long as you worked and earned it as income but did not earn more than \$65,000. If you are single the limit is \$45,000. Non-working spouses can contribute to a traditional (deductible from your taxes) IRA, if your Adjusted Gross Income does not exceed \$150,000). Please call me if you want to discuss Non-deductible IRAs and Roth IRAs.

Identity Theft – A Growing Threat

“Identity Theft” is a concept that at most everyone has heard about, but few are aware of the explosive growth of what has become a very sophisticated and devastating form of theft. Simply stated, a thief or organized group of thieves acquire a variety of personal information about you and use it to access your accounts or set up new ones in your name. Much of this information is readily available, and other information may be simply stolen from an unsecure mailbox. The ease and speed with which this can be accomplished, the losses that result, and the complexity and time required to stop the activity, are likely to be costly and nerve-wracking. Actual dollar losses are seldom recoverable; furthermore, they often pale in comparison to the hassle factor.

What are we doing?

In general, we have always paid serious attention to security issues, especially regarding client information, and we continue to be sensitive in this area. The most obvious changes that you will see shortly are the following:

- **Quarterly Reporting** – In the past, all quarterly reports have had your Charles Schwab & Co. account number provided under your account name for easy identification. In all future reporting only the last four digits of the account number will appear, following four X's (for example, XXXX-1234). This should allow you to easily identify the account, but there will not be sufficient account information for anyone else to identify the account if your reports fell into the wrong hands.
- **Data Confirmation Form** – Very shortly you will be receiving a form from us that shows all your current data we have on file, who is authorized to have access to information regarding your accounts, and who is authorized to receive copies of reports and statements. Your prompt attention to this form will help us ensure that information regarding your accounts is only made available to those whom you specify, and then only with respect to information that you specify.

What should you do?

First, please consider this seriously. We do not believe that the public is yet fully aware of the scope of this problem. We have enclosed some helpful tips from the U.S. Postal Inspection Service. At a minimum, please consider the following:

- Secure your mail by installing a secure mailbox (if you do not currently have a slot in your door or garage door) or re-routing your mail to a P.O. Box.
- Use a paper shredder to shred all personal documents before throwing them away, including the pre-approved junk mail you receive.
- Remove yourself from marketing lists by sending a postcard with your name, address and signature to Mail Preference Service, Direct Marketing Association, P.O. Box 643, Carmel, N.Y. 10512. It can take several months to stop the mail, but it does last for five years.
- Stop credit card solicitations with a single phone call (888) 567-8688 or online at www.optoutprescreen.com. You have to give them your name, address, Social Security number and date of birth, but it's good for five years
- Regularly check your credit report at one of the three major credit agencies. This is to make sure no one has stolen your identity:
 1. TransUnion, 800-888-4213 (www.tuc.com); or
 2. Experian, 888-EXPERIAN (www.experian.com); or
 3. Equifax, 800-685-1111 (www.equifax.com).

We are not suggesting that you become obsessive or paranoid, but are simply pointing out that by taking some relatively simple steps it's possible to go a long way in protecting yourself. We strongly encourage you to do so.