

Providing professional investment management to individuals, retirement plans, and charitable organizations since 1930.

AT A GLANCE

PAGE 1

Interference in the Marketplace

PAGE 3

Bond Market Overview

PAGE 4

Are You a Financial Adviser?

Interference in the Marketplace

The three I's—interest rates, inflation and Iraq—were the main focus for investors in the 2nd quarter. The stock and bond markets have been unable to gain much traction in 2004 because of these three concerns. At the time of this writing, the S&P 500 index was moderately positive and the Lehman Intermediate bond index was slightly negative. During this quarter, the stock market on May 17 reached a point well below the starting point for the year. Since then there has been a good recovery, and the markets are attempting to make further progress.

The market does not appreciate uncertainty, and uncertainty is the perfect word to describe investor concern over the timing and extent of expected interest rate increases by the Fed and the instability in Iraq. Fortunately, much of the uncertainty may start to diminish after June 30, when self-governance is turned back over to the Iraqis. This is also the same day that Alan Greenspan and the Fed will most likely start increasing the Fed Funds rate.

Historically, the months leading up to a Fed Funds rate increase are the worst for the stock and bond markets. As the table shows below, investors settle down after the rate increases start, most likely because the stock market appreciates the certainty of the Fed taking action. But keep in mind that increases in interest rates are a direct reflection that the economy is strengthening, corporate profits are likely recovering at a good rate, and the ensuing consumer and business confidence increases do much to appease investor concerns. The fundamentals are aligning nicely; now, we need investor confidence to follow suit.

S&P 500 Returns After Initial Fed Rate Hikes

Days Out	Mean Gain	Med Gain	Total Cases	Num Up	Num Down	All Days Mean
5	0.9	0.7	18	12	6	0.1
10	0.2	-0.1	18	8	9	0.3
22	0.7	0.7	18	10	8	0.6
63	1.8	-1.3	18	7	11	1.8
126	4.7	5.1	18	11	7	3.5
252	8.8	7.1	18	12	6	7.2

Ned Davis Research, Inc.

U.S. Economy Picking Up Steam

The last piece of the economic puzzle fell into place during the 2nd quarter. In our last newsletter, we addressed the jobs "issue" raised by the Democratic hopefuls in the primaries. As we suspected in March, jobs have swiftly become a non-issue. The number of jobs in the United States, including manufacturing jobs, has increased dramatically and unemployment has stayed flat. The May numbers were a strong increase of 248,000 jobs with manufacturing employment up 32,000 and unemployment holding steady at 5.6%. The economic focus shifted dramatically from the 1st quarter to the 2nd quarter from worry about job creation to concern over inflation. We anticipate that as the jobs situation continues to improve, sentiment about the economy as a whole will improve and investor confidence will follow suit.

There is reason to be concerned about inflation over the short term primarily because the economy is performing so well. Retail prices were up 1.2% in May, 0.2% higher than expected according to the Commerce Department. Automotive sales rose a strong 2.7%, the biggest gain since November, while all other goods were up 0.7% for the month after April's retail sales fell 0.6%. High oil prices continue to be of concern. Business capital expenditures have been increasing, but profits have been increasing even more, creating a positive financing gap, which should help keep business spending strong.

Whither the Presidency?

As the election approaches and, according to polls, with the country evenly split between the two presidential candidates, we have been asked with increasing frequency, "What impact will the election have on the stock and bond markets?"

Interestingly enough, the stock market has performed better under Democratic presidents than under Republican presidents. However, the opposite can be said of election years, especially when an incumbent Republican has won the election.



Business capital expenditures and corporate profitability continue to rise, job growth is solid and the country's economic growth is strong. Inflation should remain low and interest rates should rise, but probably at a moderate pace. These are basic and essential ingredients for a strong stock market. The bond market is continuing to struggle with the prospect of higher interest rates, but our defensive strategy of holding short-term bonds should protect portfolio values.

Gains for Stocks, Economy and Inflation by Party of President and Majority Party in Congress 03/04/1901 – 4/14/2004

	Gain/Annum (%)				Time (Years)
	Stocks (DJIA)	Industrial Production	Inflation (CPI)	Real Return	
Dem. President	7.2	5.4	4.6	2.6	47.9
Rep. President	3.7	2.0	1.7	2.0	55.3
Dem. Congress	6.5	4.8	4.5	2.0	65.9
Rep. Congress	3.3	1.4	0.5	2.8	37.3
Dem. Pres., Dem. Cong.	6.6	6.5	4.8	1.8	37.8
Dem. Pres., Rep. Cong.	9.6	1.2	3.8	5.8	10.0
Rep. Pres., Rep. Cong.	1.1	1.5	-0.7	1.8	27.3
Rep. Pres., Dem. Cong.	6.3	2.6	4.1	2.2	28.0
Total Period	5.3	3.6	3.1	2.2	103.1

Real Return = Stock Return - Inflation Rate

Party in control of Congress is determined by averaging percentage control in the Senate and percentage control in the House. Dates used in study are presidential inauguration dates. The only Democratic presidents who had to contend with a Republican Congress were Wilson (1919-1921), Truman (1947-1948) and Clinton (1995-2001). Latest available index value for Industrial Production & CPI is used.

Ned Davis Research, Inc.

Lower real returns have been seen with either a Democrat president and a Democrat Congress or a Republican president and Republican Congress versus the higher returns under "gridlock"—when the President is one party and Congress the other party. Investors must prefer the checks and balances of different parties controlling Congress and the Presidency than having one party able to pass economic policies unhindered.

The stock market has tended to perform worse in an election year's first half than its second half, though it has tended to sell-off in advance of an incumbent loss.

DOW Industrials Monthly Returns Since 1900

Month	Incumbent Wins		Incumbent Losses		All Election Years		Non-Election Years	
	Mean % Gain	% of Time Up	Mean % Gain	% of Time Up	Mean % Gain	% of Time Up	Mean % Gain	% of Time Up
Jan	0.23	53	-0.48	40	-0.04	50	1.42	68
Feb	-0.46	50	-1.59	40	-0.83	48	0.13	51
Mar	2.80	88	1.31	60	2.06	74	0.24	56
Apr	-0.87	44	-2.26	40	-1.41	42	1.95	59
May	-0.73	56	-1.87	40	-1.17	50	0.29	53
Jun	1.04	62	0.61	50	0.87	58	0.22	49
Jul	1.99	56	2.65	50	2.24	54	1.00	64
Aug	2.59	81	3.86	50	3.08	69	0.38	62
Sep	0.61	44	-1.05	40	-0.03	42	-1.60	40
Oct	2.95	88	-1.52	40	1.23	69	-0.13	52
Nov	3.75	69	-0.40	60	2.15	65	0.53	60
Dec	0.99	62	0.55	50	0.82	58	1.76	78
Jan-May	1.78	60	-4.53	40	-0.75	52	4.12	65
Jun-Dec	14.70	94	4.24	60	10.68	81	2.15	63

Ned Davis Research, Inc.

As far as the Fed and raising rates impacting the election, the Fed has tended not to raise rates in September and October of election years, being concerned that their moves could be viewed as having political overtones. We don't believe that a Fed rate hike would necessarily prevent Bush from being re-elected. Of the seven post-WWII presidential election years in which the Fed hiked rates, the incumbent party won four times, demonstrating that the true impact of Fed interest rate changes just before an election are quite inconclusive on the outcome of the election.

When the economy is strong and unemployment low, the party in power tends to stay in power and vice versa. Two obvious exceptions were 1952 and 1968 when Democrats lost power despite a healthy economy. Both of those years were marked by increasing voter frustration over war policies.

Post War Presidential Elections vs. Economy 1948 - 2000

Election Year	Party In Power (Democrat/Republican)	Real GDP (%)	Unemployment Rate (%)	Incumbent Party Win/Lose
1948	D	4.4	3.8	Win
1952	D	3.8	3.0	Lose
1956	R	1.9	4.1	Win
1960	R	2.5	5.5	Lose
1964	D	5.8	5.2	Win
1968	D	4.8	3.6	Lose
1972	R	5.3	5.6	Win
1976	R	5.3	7.7	Lose
1980	D	-0.2	7.2	Lose
1984	R	7.2	7.5	Win
1988	R	4.1	5.5	Win
1992	R	3.3	7.5	Lose
1996	D	3.7	5.4	Win
2000	D	3.7	4.0	Lose
Median		3.9	5.4	
Median Non-Election Years		3.4	5.6	

Ned Davis Research, Inc.

What does all of this mean? First of all, we have mostly good news. Business capital expenditures and corporate profitability continue to rise, job growth is solid and the country's economic growth is strong. Inflation should remain low and interest rates should rise, but probably at a moderate pace. These are basic and essential ingredients for a strong stock market. The bond market is continuing to struggle with the prospect of higher interest rates, but our defensive strategy of holding short-term bonds should protect portfolio values. Putting it all together, we think it is reasonable to expect relatively strong stock market performance for the rest of 2004, on balance.

Bond Market Overview - 2nd Quarter 2004

The beginning of the second quarter started with a jolt to the bond market. Once again, the catalyst was new job creation. While the March employment data was well below expectations, the April numbers were significantly above: 308,000 new jobs were created when only 120,000 were expected. On the day of the announcement, interest rates increased dramatically, rising approximately 30 basis points (0.3%). The increases continued even after the April employment data was released. Treasury yields have risen between 1% and 1.25% since the end of March. Why? In the last three months through May, over 900,000 new jobs have been created.

Inflationary Pressures

In our last newsletter we emphasized that the missing component to the market's expectations of higher inflation was rising employment costs. Other signs of inflation were already present, but because of high productivity in the economy there was little need for businesses to hire. The most recent data shows productivity is now rising at a slower rate and employment costs are increasing. Coupled with persistently high energy prices, personal consumption increases and more spending by businesses, it's reasonable to expect the Federal Reserve will increase short-term rates from the exceedingly low level where they currently lie.

Through the recent rapid rise in bond market yields, the Bond market has already anticipated the Federal Reserve increasing short-term rates. However, the market is uncertain about how much rates will rise, and how long it will take the Federal Reserve to slow down or reduce any potential inflationary pressures. Expectations are for a 25 basis point rise (0.25%) in June, followed by another 50 to 75 basis point increase during the remainder of 2004. This would put the Federal Funds rate at close to the current year-over-year core rate of inflation of 1.8%. However, with the trend in inflation picking up recently, the measurement of core inflation may be higher by year end. Historically, the Federal Funds rate usually is as high as inflation and in most cases tends to exceed trailing 12-month inflation. So, it's not unreasonable for the market to expect a 2% short-term rate by year's end. We have no reason to believe otherwise. The timing may not coincide exactly with the market's expectations since this is a presidential election year. The Federal Reserve has historically been reluctant to raise rates beyond the month of August in such years.

Why Bonds During Inflationary Cycles?

Conventional wisdom implies that we should hold or purchase bonds during stable or deflationary periods and sell them during inflationary ones. This "all or nothing" proposition requires perfect timing as well as clairvoyance, and an enormous amount of good luck. The next best proposition is to identify inflationary/deflationary trends and adjust the average maturity of bond portfolios accordingly. That is why we have intentionally structured our clients' bond holdings to focus on shorter term bonds. Since shorter maturity bonds are not as price sensitive as longer bonds, one is able to preserve more capital and take advantage of a future rise in interest rates. In the time that bond yields have increased 1% to 1.25%, an investor in shorter term bonds would have lost 2 to 2.5%, while an investor holding longer maturity bonds would have lost more than 6% to 7%. The market will provide an opportunity to reinvest that capital at higher yields.

A recent commentary¹ regarding bonds and rising interest rates presented an interesting statistic from a study conducted by the author. If investors had bought long-term bonds or bond funds just before periods of rising interest rates, they asked, what would have been the returns? The author studied bad years for bonds (1984, 1990, and 1994) and measured their subsequent five-year performance. The results showed that in 1984 the investor would have lost 8% but finished the five-year period (through 1988) with an annualized gain of 5.3%. For 1990 and the subsequent five-year period, the loss and ultimate gain was -7% and +10.1%. For 1994, -3.9% and +7.8%.

One should be cautious about interpreting these results as the norm. One should never rely on only three events over time for statistical significance in forecasting future events. The fact that interest rates have been in a downward cycle for the past two decades does not mean that it has always worked out so neatly. The author rightly points out that if one were to go back to the 1970's when interest rates were in the double digits, one would be hard-pressed to have broken even in bonds or bond funds. Are we headed for a 1970's cycle? We don't think so. The foremost reason is the Federal Reserve itself. The Federal Reserve is legally bound to maintain price stability. They are equally vigilant to inflationary pressures as they are to deflationary pressures. The inflationary cycle of the 1970's was primarily caused by a bad supply shock (oil) and monetary response to the inflation that was produced by that shock. Now we have higher energy

¹"Hanging in with bond funds as Interest rates rise": Chet Currier, 5/25/2004, Bloomberg"

We at Howe & Rusling are best considered as your “Partner in Progress” and are available to help you wade through the complexities of good financial planning and strategy. We work hard to earn and retain the position of “Trusted Advisor” to our clients.

prices as a result of greater global demand, not because producers are unwilling to increase supply. Another important aspect is that the level of productivity is much higher now than in the 1970’s. The global economy can produce more efficiently and cost-effectively, thereby keeping wage inflation lower than was possible in the 1970’s.

Yield Curve & Tightening Cycles

When the Federal Reserve does begin to increase short-term rates, we expect a flattening of the yield curve. Simply put, short-term rates increase more than long-term rates. Short rates respond to changes in monetary policy while long rates are driven by expectations of future inflation and the demand for long-term capital. When the market feels confident that inflationary trends are under control, long-term rates will stabilize and ultimately decrease.

Currently the market is uncertain about how aggressive the Federal Reserve will be in raising rates. While Chairman Greenspan and other board members have talked about patience and measured responses to inflationary pressures, the bond market is expecting a more aggressive raising of rates. As recently as June 8, Mr. Greenspan said the central bank is “prepared to do what is required” to stem inflation. Given the uncertainty of how aggressive and how long the tightening cycle will last, we remain underweight with respect to our benchmark in our target duration of bonds. The time will come when we will act to increase the average maturity and lock in higher yields.

Are You a Financial Adviser?

A client of long standing recently posed this question to one of our portfolio managers. It raises a larger question: “Who really does what in the business of financial advice?”

In answer to this client’s question, our manager’s response was of course, “Yes, I do this work on behalf of our clients.” Advising our clients on comprehensive financial matters is part and parcel of our work. We make no additional charge for this service, as it is our belief that good investment management should not be separated from a client’s underlying needs and wishes.

This client had recently sold her home, and wanted to make certain that she made wise decisions with this large wind-fall of cash. She had intelligently put the proceeds into a bank’s money market program that afforded her complete flexibility on how she would later deploy the money.

A meeting between her and her Howe & Rusling portfolio manager laid that groundwork for how that money would be used within her family setting, and how the investing would create the expanded cash flow she desired from her portfolio.

Financial Agendas:

This client might have sought other advice on how to invest this large cash receipt. The vast majority of “financial advisers” would recommend that she purchase an “investment product” such as an annuity or a mutual fund, either of which would entail large sales commissions. Additionally, these choices also include significant ongoing annual management charges, usually larger than the management fee assessed by an investment counsel firm such as Howe & Rusling.

The labels assumed by different “financial advisers” have become confusing and varied. People who used to be called “stock brokers” have gone through many iterations of their titles, from “financial consultants” to “account executives” to just about anything you can imagine, including our coveted title of “investment managers” or “investment counselors.” Knowing how your advisor is compensated can help you understand if that advisor has an agenda which may not be compatible with your best interests, as the client.

Rest assured, your Portfolio Managers here at Howe & Rusling, as well as the company itself, receive no compensation other than our investment management fee. Therefore, we are in the singular position of being able to render non-biased advice, as we receive no pecuniary advantage by changing our advice in any particular direction.

A Call to Action:

If you believe it is a good idea to have a special conversation with your H&R Portfolio Manager regarding the strategy employed in your portfolio, or estate planning matters, or planning cash flow for your needs, PLEASE: give us a call, and we will respond quickly and in depth. We at Howe & Rusling are best considered as your “Partner in Progress” and are available to help you wade through the complexities of good financial planning and strategy. We work hard to earn and retain the position of “Trusted Advisor” to our clients.

Should Charitable Giving be Part of Your Estate Plan?

Philip L. Burke, Esq. Woods Oviatt Gilman, LLP

JULY 2004

With the increase in the federal estate tax exemption in 2004 and 2005 to \$1.5 million, the idea of charitable giving as part of an estate plan seems to have been put on the back burner. Since estate taxes may become less of a concern, does that mean that your charitable giving desires should be given lesser consideration as well? Maybe—from the estate tax perspective—but there are other reasons to give to charity. In addition to the “feel good” benefits you get from helping out your favorite organization, the financial benefits should not be dismissed. For example, many individuals have substantial retirement funds as part of their estate. These funds, on distribution to beneficiaries, would be subject to the payment of income taxes by the beneficiaries, at their particular tax bracket. Distributing these taxable funds to a charity, as part of the overall distribution plan for your estate, may result in substantial income tax savings over time.

There are many options available to you with regard to charitable giving, and this article will address four of the more significant ones that you may wish to consider: outright giving, Charitable Remainder Trusts, Charitable Lead Trusts and Private Foundations.

Obviously, the simplest way to benefit your favorite charity is to make an outright gift during lifetime or at death as part of your overall estate plan. Lifetime gifts to qualified charities will result in an income tax deduction (please consult your tax advisor!), and will also remove the gifted asset from your estate. Outright bequests to charities as part of an estate tax plan are, dollar for dollar, deductible against both federal and New York estate taxes. This is true regardless of whether or not your gift is minimal (“I give and bequeath the amount of \$5,000 to the XYZ charity”) or substantial (“I give and bequeath the amount of \$1,000,000 to the XYZ charity”). From a pure tax perspective, individuals with no close relatives, or whose beneficiaries already have substantial assets of their own, can use outright charitable gifts to not only benefit their favorite charities, but also substantially reduce or eliminate the payment of any estate taxes.

The obvious drawback with an outright gift to charity is that the donated money will not be available for the benefit of your surviving family members. If you want to benefit both family members and your favorite charity, you should consider either a Charitable Remainder Trust or a Charitable Lead Trust. Both of these trusts allow family members and the charity to receive benefits over time.

You can use a Charitable Remainder Trust (“CRT”) in those instances where an outright gift to charity is less desirable due to the fact that surviving family members may require the initial use of, or access to, the funds otherwise designated for charitable purposes. This type of trust can provide that the beneficiary (for example, your spouse) would receive annual distributions of at least five percent of the value of the assets held in the trust for his or her lifetime with the trust property passing to your favorite charity upon the subsequent death of the beneficiary. A CRT set up during lifetime can provide you with substantial income and potential capital gains tax benefits, or can be set up at death, as part of your estate plan, to reduce overall estate taxes. Also, if a CRT is funded after death with assets held in your retirement account, these funds can pass free of any *current* income taxes to the trust to be invested and held for the benefit of the beneficiary. The calculation of the estate tax benefits available through the use of a CRT is subject to too many variables to be discussed here, and should be reviewed on an individual basis.

If you need a bigger “upfront” estate tax deduction, you should consider setting up a Charitable Lead Trust (“CLT”). A CLT is basically the opposite of a CRT, in that the charity receives the annual payments from the trust for a period of years with the balance, after the term of years has passed, to be paid to your family members. CLT’s are usually created at death to provide the estate tax deductions you may need, but can be created during lifetime (although the tax issues for a lifetime CLT require more in-depth analysis). The estate tax savings generated by a CLT are often greater than those provided

by a CRT due, primarily, to the fact that the charitable interest is paid out first, with the balance passing to your family members. As indicated above, under a CRT, the charity has to “wait” for its distributions until the termination of the trust.

Your decision whether to use a CLT or CRT involves the review of many different issues, such as potential estate taxes and estate tax savings, income tax issues (especially those involved with taxable retirement accounts), capital gains tax concerns, the age and financial needs of the trust beneficiaries, and others.

Another charitable planning option for you to consider involves the use of a Private Foundation, or the creation of your own charity. A Private Foundation can be created and used as the recipient of the charitable contribution (either during lifetime or at death) and the Board of Directors of the Foundation (usually you and other family members) decides on how those charitable dollars will be allocated to and among other qualifying public charities. In other words, a Foundation gives the family the ability to distribute their charitable dollars among several worthy recipients, as opposed to a direct one-time gift to a few selected organizations. The creation of a Private Family Foundation is not difficult, but does involve some initial time and effort, as well as annual administrative obligations.

Depending on the amounts intended to be contributed, and the extent of your control of the disposition of the charitable dollars, another alternative is to make a gift to a “Community Foundation.” A Community Foundation is, in and of itself, a public charity through which individual charitable “family funds” can be created. Very often, you and your family will be involved in the decision-making process with regard to qualifying charities that ultimately receive the distributions from the family fund. The benefit of using a Community Foundation lies in the fact that it is “ready-made” and does not require the time and effort involved in creating and maintaining a Private Family Foundation.

In conclusion, even with the increases in the estate tax exemption amounts, charitable giving should always be included as part of the discussions of your estate plan. This is even true in situations where there are no estate tax issues to be concerned with, and you want to help out your favorite charitable organization. Also, as can be concluded from these discussions, this is not a “one size fits all” issue. Rather, these options and, possibly others, should be discussed with your advisors to determine which charitable giving option, if any, is most appropriate for your situation. If you would like to discuss these concepts in more detail, please contact your Howe & Rusling Portfolio Manager to arrange for a no-obligation meeting.



HOWE & RUSLING