

PERFORMANCE RESULTS
(pg 11)**Positive Results Through Mid-Year****Articles****Charitable Giving:
An Array of Choices**

- Choosing a method for funding charitable gifts can be almost as difficult as deciding which charities to support. The "best fit" vehicle often depends on the donor's time frame and desired level of involvement... (pg 3)

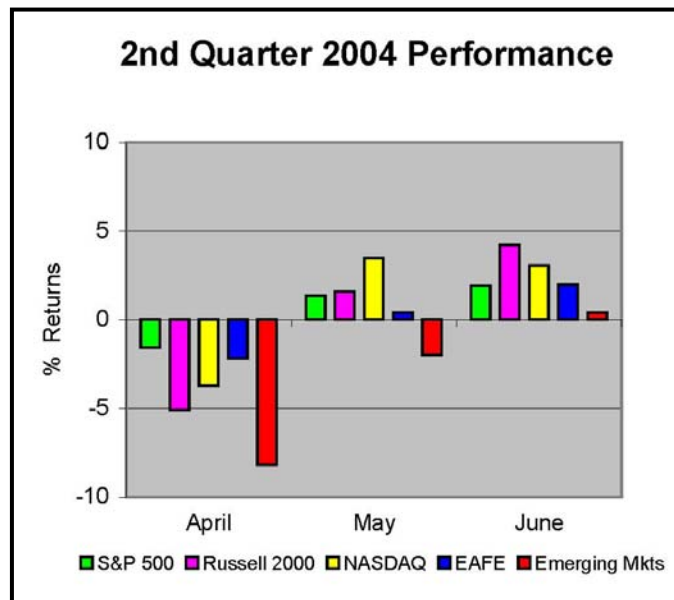
**Rebalancing and
Re-Weighting –**

During June we conducted our annual rebalancing process-- adjusting each client's portfolio back to the target asset allocation of the client's investment plan. (pg 7)

Manager Watch:

- This quarter we are focusing on the two managers we use to gain "value-oriented" exposure in domestic large capitalization stocks: Berkshire Hathaway and DFA US Large Cap Value (in tax-exempt or tax deferred accounts) or DFA US Tax-Managed Marketwide Value (in taxable accounts). (pg 8)

The second quarter ended with the long expected reversal of interest rate policy, with a .25% increase in the federal funds rate, and the formal restoration of sovereignty to Iraq, two days earlier than originally planned. Dramatic? Perhaps, but no surprises.



On an overall basis, this past quarter produced almost no net change in market values, masking a rather sharp retrenchment and recovery early in the quarter and a broad divergence among asset classes. Domestic stocks were up, absolute return funds flat, fixed income down (as interest rates increased in anticipation of the Federal Reserve's quarter-end move), and overseas stocks down...from a little (developed markets large cap) to a lot (emerging markets).

Thus, depending on their specific asset allocations, our clients have experienced nearly flat performance for the quarter, from small positive results to a little give-back from robust results in the first quarter. In many respects

this was a period of digesting the rich investment rewards of the prior four quarters, with investors awaiting the Federal Reserve's deeds (and words), assessing the durability of economic and jobs recovery, while continuing to hold their breath in fear of terrorist activity over the especially target-rich year of 2004.

Thus far, then, at the half-way point, 2004's investment performance is at about the pace we continue to expect for the whole year: a high single digit net investment return for most clients' portfolios.

Interest Rates and Inflation

Among many candidates, our vote for the biggest investment "story" of the second quarter was the interest rate question, but not whether rates would rise – everybody expected that – but by how much. The Fed previewed over many months not only that they would raise short term rates but that they would do so slowly and gradually, convinced that rising inflation was not a significant threat. This had the intended impact of encouraging the market to increase longer term rates and gave traders time to at least begin to unwind their "carry trade" exposure, thus avoiding a sudden and disruptive correction in fixed income markets. Nevertheless, quite a few commentators fear that the Fed was, and is, behind the curve, believing that published CPI-inflation is actually understated and, in any event, is primed to increase as the stimulus of very low interest rates and deficit spending combine with recovery in the economic fundamentals. While oil prices have receded from their recent highs, we can't see much room for further declines in that area as global economic growth increases demand, and events in the Mid-East continue to threaten fragile supply.

Another interesting inflation discussion surrounds the proper role of housing costs. CPI is now calculated with a “rent equivalent” component. As residential property values have skyrocketed, rents have fallen thus, some argue, understating the real cost of housing. On the other side, defenders of the CPI point out that ownership costs like mortgage payments are also low and reflect the acquisition and maintenance of an asset. That asset’s full costs and benefits are not appropriate, they argue, to be reflected in a price index that reflects the costs of *purchases* but says nothing directly about the proceeds of potential sales.

In any event, if the pace and size of interest rate increases manages to maintain reasonable price stability and fosters sustainable rates of growth, the impacts on equity markets should be positive. Whether the Fed has it right at this point we cannot say for sure; but we’re not inclined to bet against the track record of Greenspan and his colleagues in the Fed.

More Emerging Markets Mayhem

A close runner-up story was the sharp correction in emerging markets this past quarter. Most of our clients have some exposure to the difficult to define “emerging markets” asset class, but, typically, those exposures are small so the impacts on an overall portfolio, good or bad, are fairly muted. Many investment commentators, and a few of our clients, have a love/hate relationship with emerging markets, gushing with enthusiasm when they do well (for example the 80% aggregate returns for the four quarters to 3/31/04) and ready to abandon them when they give some of that return back, like the 9 to 10% declines this quarter.

The big players this quarter were China, which is trying to avoid an overly heated rate of economic growth, and India, whose electoral surprise caused initial fear of a return to Nehru-esque socialism and a command economy. China is, in our view, in the unenviable state of being damned if it doesn’t apply the brakes and damned when it does. India was quick to allay the market’s worst fears by installing a free-markets economist as Prime Minister.

We continue to believe that equity investment in these and other rapidly developing countries presents significant opportunity for additional portfolio performance. So, whether China is able to engineer a soft landing or, like most rapidly developing countries before it, hits hard, we encourage our clients to maintain a consistent commitment to these markets. Attempting to optimize the timing of that exposure seems to us especially difficult, as likely to miss the large potential upsides—consumer demand in some of these markets is just now starting to ignite—as it is unlikely to confidently avoid the downturns.

The Second Half

The far from conclusive situation in Iraq, with the shame and horror of Abu Ghraib adding to the increasing costs in lives and money, also weighed heavily on world-wide markets this past quarter. What is important going forward is whether markets perceive any improvement in a situation

some have written off as already lost. So far, the re-establishment of sovereignty to Iraq and the arraignment, by an *Iraqi* court, of Saddam Hussein have spurred no *exceptional* acts of terrorism. If the Boston and New York City conventions, the Athens Olympics, and the election itself escape any dramatic disturbances, the markets will probably take increasing comfort. If not, the impact on investor sentiment could of course be very ugly.

Election years have historically been quite good for the US stock market and many commentators believe that the market would respond better to a Bush victory than for Kerry, based primarily on perceived impacts on domestic spending and tax policies. While foreign affairs are providing a lot of rhetorical heat in this election season, we doubt that there can be any significant difference in actual policies regarding Iraq or international trade, for example, regardless of the election’s outcome. And, unless either presidential winner carries a convincing majority in both houses of Congress (which seems to us very unlikely), some form of gridlock would probably forestall any major change in domestic policy, as well. As frustrating as that may be for voters toward either end of the political spectrum, it will probably suit investment markets just fine.

Most significantly, the domestic economy is good and getting better. First quarter real GDP growth was at a 3.90% annualized rate and estimates for the quarter just finished are in the 3.5% - 4.0% range. Corporate earnings are strong (the increasing “E” has driven the S&P 500 P/E ratio down to about 20) and, with a slowing in the June numbers, well over 1.2 million new jobs have been added since March. Long pent-up corporate spending may add to consumer demand that may not be exhausted after all. Consequently, the market’s side-ways moves over the last quarter have made stocks “cheaper” than they were a few months ago.

Fiscal deficits, while worrisome, may be a lesser problem than some fear. Despite their absolute size, current deficits are far smaller relative to the size of gross domestic product and are being financed at far lower interest rates than the benchmark deficits of the Reagan years. Some combination of tax policy, spending policy, and economic performance will make the deficit situation better or worse; no one of those dimensions can carry all of that weight; however we expect the economy to do most of the work in successfully bringing deficits down to more comfortable size.

In sum, then, we continue to believe that 2004 will produce quite respectable results for our clients’ portfolios. Except for the continuing uncertainty about further major acts of terrorism, the overall economic picture is now clearer...and, for investment markets, that alone makes it brighter.

Tim Kochis, Editor

Charitable Giving: An Array of Choices

Choosing a method for funding charitable gifts can be almost as difficult as deciding which charities to support. The “best fit” vehicle often depends on the donor’s time frame and desired level of involvement, as summarized in the accompanying Table.

Quick, Easy, and Inexpensive

Sometimes, the quickest and easiest ways to fund a charitable giving program is simply to write a check, direct gifts through an employer-provided payroll deduction program, or use a credit card. Checks and credit cards are especially appropriate for smallish donations, including the purchase of raffle tickets or the cost of attending charitable events, and have the advantage of easy tracking and recordkeeping for tax reporting purposes.

If you have highly appreciated stocks, mutual funds or other capital gain property that you’ve owned for more than 12 months, a direct gift of those appreciated investments is usually preferable to cash. By giving away long-term appreciated property, you secure a charitable deduction equal to the fair market value of the investment and avoid paying capital gains tax on the unrealized appreciation. By avoiding the gains tax, you reduce the after-tax cost of the gift, making gifts of appreciated assets cheaper than equivalent cash gifts. Consequently, we commonly transfer appreciated stocks and mutual fund shares to charities for our clients’ larger charitable gifts.

But, there are some important limitations on gifts of appreciated assets. Charitable gifts funded with cash are limited to 50% of your adjusted gross income (“AGI”) for the year of contribution, while gifts funded with capital gain property are limited to 30% of AGI. Further, the limitation for gifts to private foundations is further reduced to 20% of AGI for appreciated property (30% for cash). If a taxpayer makes gifts in excess of any of these AGI limitations, the excess contributions carry over to the next 5 tax years.

In terms of cost, direct gifts, whether of cash or appreciated property, are inexpensive when compared with the alternative options described below, each of which involves material setup and/or ongoing administration costs.

Donor Advised Funds – A Common Solution

Making charitable gifts using appreciated investments generally makes sense only for gifts over \$2,500 due to the operational hassles of transferring stock or other assets directly to charities and the burdens of tracking all this activity for tax purposes. Consequently, most people fund smaller charitable gifts with cash, logistically easier, but without the ancillary benefit of transferring an appreciated asset out of the donor’s estate. There is a better way.

An increasingly popular charitable giving tool, a donor-advised fund, solves the logistics problem and enables

donors to conveniently use appreciated securities even for relatively small charitable gifts. Here’s how it works: A donor makes a sizable gift of appreciated property (at least \$10,000) to a community foundation or other public charity that offers donor-advised funds. The donor claims an immediate tax deduction for the full value of the gift, subject to the AGI limitations discussed above. The sponsor charity then sells the appreciated asset tax-free, and the donor then “advises” the sponsor charity on when and how to distribute the proceeds to other charities of the donor’s choice. Because many donor-advised funds allow distributions in increments as little as \$250, these vehicles can replace most cash gifts.

Donor-advised funds also offer flexibility as to the timing of gifts. The donor can distribute money out of a donor-advised fund to charities soon after the gift is made, or over a period of many years. In fact, some donor-advised funds allow the donor to name successors (e.g., children or grandchildren) who, upon the death of the original donor, can step into the donor’s shoes and continue advising the sponsor charity on distributing the family’s largesse over even multiple generations. Meanwhile, the charitable gift “account” is invested in a pool of equities and fixed-income investments that should grow over time, adding to the pool that the donor can distribute.

As part of its role being the “conduit” for the donor’s charitable gifts, the sponsoring charity takes care of all the administrative work and tracking of information for tax purposes so that donors can leverage their time and focus solely on grant-making. Many sponsors also provide donors with assistance in locating and evaluating charitable organizations to receive grants. For larger donors, sponsors will even follow up with charities that have received grants to ensure that the charity has used the grant effectively.

A compelling way to use a donor-advised fund is to time gifts to the fund to coincide with high-income years in order to “pre-fund” future years’ planned charitable gifts. For example, if you plan to make \$50,000 of annual charitable gifts each year and in 2004 experience a particularly high-income year (e.g., from the exercise of stock options) then you could establish a donor-advised fund with, say, a \$200,000 gift, and pre-fund your next 4+ years of philanthropy, while simultaneously taking full advantage of the charitable gift tax deduction at the highest marginal tax rates in the year of contribution.

Similarly, a donor who is hesitant to sell very highly appreciated stock (due to a high tax bill, for example) can contribute the stock to a donor-advised fund to create a pool of resources for future gifts. The donor receives an immediate tax deduction for the full value of the gift (over the year of the gift and the following five years, as necessary), the stock is sold tax-free within the fund, and the proceeds are allocated to a diversified portfolio. The donor-advised fund then replaces the donor’s future planned cash giving.

Attributes of Charitable Vehicles UPDATED JANUARY 2004

	GRANT MAKING CONTROL & BENEFICIARY CHOICE	WORK REQUIRED BY DONOR	SETUP & ADMIN. COSTS	OPERATIONAL CONTROL & INVESTMENT FLEXIBILITY	PRIVACY	OPPTY FOR DEDUCTION NOW, GIFT LATER	COST EFFECTIVE THRESHOLD TO ESTABLISH	MULTI-GENERATIONAL	TAX DED. LIMIT (%AGI) FOR CASH/LTCG PROPERTY	SPECIAL FEATURES & TAX-RELATED ISSUES
<i>Payroll Deductions</i>	LOW	LOW	LOW	N/A	HIGH	NO	SMALL	NO	50%/N/A	N/A
<i>Direct Gifts</i>	MEDIUM	LOW/MEDIUM	LOW	N/A	HIGH	NO	SMALL	NO	50%/30%	N/A
<i>Donor-Advised Fund</i>	MEDIUM	LOW/MEDIUM	MEDIUM (-1%)	MEDIUM	HIGH	YES	\$10,000	Yes/No	50%/30%	N/A
<i>Supporting Org. to Public Charity</i>	MEDIUM/HIGH	MEDIUM/HIGH	MEDIUM/HIGH (-1%+)	MEDIUM/HIGH	MEDIUM	YES	\$1-3 MILLION	YES	50%/30%	<ul style="list-style-type: none"> • Institutional discipline • Philanthropic resources
<i>Private Foundation</i>	HIGH	HIGH	HIGH (-1.5%)	HIGH	LOW	YES	\$3-5 MILLION	YES	30%/20%	<ul style="list-style-type: none"> • Excise tax (1%) • Min. payout (5%) • Family employment • Deduction: <ul style="list-style-type: none"> - FMV for publicly traded assets - Basis for other property
<i>Charitable Trusts (Lead and Remainder)</i>	MEDIUM	MEDIUM	MEDIUM	MEDIUM/HIGH	LOW	YES	\$1 MILLION	YES, BUT LIMITED	50%/30%	<ul style="list-style-type: none"> • CLT: Return of asset after lead • CRT: Income stream before passing to charity • CRT: Tax on LTCG gift deferred

While donor-advised funds are an ideal solution for many clients, they are not perfect for everyone. After property is contributed to a donor-advised fund, it becomes the property of the sponsoring charity, and the charity is under no legal *obligation* to accept donors' direction of charitable gifts. In practice, this is not a real drawback because the fund sponsors rarely reject donors' advice, as doing so would severely curtail future contributions to the sponsor. Nevertheless, the donor has no direct, legal control over the sponsor's decision-making process.

A more significant drawback, perhaps, is that most donor-advised funds limit gifts to registered, domestic charitable organizations. Consequently, most funds are generally not flexible enough for the donor who wants to be directly involved with individual grantees (e.g., a scholarship fund for inner city children; or supporting specific artists' work) or international charities. Moreover, funds established through community foundations sometimes require that some portion of the contribution be *used* to support charities in the local community.

Private Foundations & Supporting Organizations – More Involved Giving

While donor-advised funds are a suitable solution for achieving most donors' charitable goals, some donors with particularly ambitious philanthropic objectives require a more complex solution that avoids donor-advised funds' limitations. Private foundations and supporting organizations are independent legal entities (unlike donor-advised funds, which are simply a service offered by a sponsoring charity), which give the donor a great deal of flexibility in executing his or her unique philanthropic vision and a more direct role in management of the organization itself.

In a private foundation, the founder and often other family members usually occupy the foundation's entire board of directors, giving the founder far greater control over grant-making, investment policy, and day-to-day operations than is the case with a donor-advised fund. A supporting organization is also an independent entity, but it is

established to support a *specific* public charity (e.g., a community foundation). The donor has a seat on the supporting organization's board, but the affiliated charity controls the board; consequently, the donor has more input...a larger voice...than with a donor-advised fund, but not the absolute control of a private foundation.

When helping clients decide if one of these vehicles is a better solution than a simpler donor-advised fund, we focus on the following key factors:

Grant-making agenda: A donor who anticipates making large and/or frequent direct grants to individuals (e.g., scholarships, artistic grants, homeless assistance) or non-US charities will generally find that an independent entity offers more grant-making flexibility than a donor-advised fund.

Permanence: Some very wealthy families want a permanent charitable giving vehicle that supports multi-generational grant-making and an extended family's long-term philanthropic mission. While a donor-advised fund can serve this purpose for relatively modest accounts, an independent entity often better fulfills this purpose when the dollars involved exceed several million.

Family involvement: Private foundations and supporting organizations both provide the opportunity for the donor's family members to join the entity's board of directors and to participate in carrying out the family's philanthropic vision. Larger private foundations often employ the donor's family members as part-time advisors or even full-time employees responsible for distributing the family's largesse, making it possible for family members to devote substantial time and effort.

Donor involvement: Certain donors, either because of the size of the gift or the nature of their personality, want to take a hands-on approach to managing the day-to-day operations of a charitable organization. Being on the board of one's own supporting organization or private foundation affords the donor an opportunity to influence the organization's investment policy, establish grant-making guidelines, retain professional staff, attend periodic board meetings, and perform other functions of managing a public charity.

Like Running a Business

The wealth generated in the late 1990s created a surge of many new, relatively small private foundations. Many of these foundations, however, are now closing down and are transferring their assets to less complicated donor-advised funds and supporting organizations. In part this is occurring because many people who set up private foundations didn't really know what they were getting into. Private foundations must distribute at least 5% of their value each year, must file annual tax returns, perform audits and complicated financial reporting, and must adhere to extensive record keeping requirements and pay the IRS a small fee for its required oversight... in short, it's like running a small business. Moreover, because private foundation tax returns are readily

available on the internet, many foundations find themselves besieged with unsolicited grant requests. All of these factors can overwhelm an unprepared donor and occupy a significant amount of time that he or she would prefer to use distributing wealth.

Fortunately, a supporting organization solves many of these problems, as the donor relies on the supported organization's administrative systems to perform most back-office functions as well as to screen grant requests. This frees the donor to focus on grant-making, while preserving the "look and feel" of a private foundation by giving the donor and his or her family a significant and permanent voice in the operation and policies of the entity.

Perhaps most importantly, supporting organizations can benefit from the experienced, professional guidance provided by the specific charities they support. This professional guidance can be particularly important and cost-efficient for inexperienced donors who often need assistance to optimize their philanthropic impact.

Other Sophisticated Charitable Gift Vehicles

Irrevocable charitable trusts are popular gift-giving vehicles among estate planners and the planned giving community. These trusts can accomplish several simultaneous objectives: creating an income stream, deferring the recognition of gain on appreciated assets, satisfying a charitable intent, and removing property from a person's estate at a discounted value. Because of the costs involved in establishing and maintaining charitable remainder trusts ("CRTs") and charitable lead trusts ("CLTs"), these vehicles usually work best with assets whose value is in excess of \$1 million.

In a CRT, the grantor funds the trust with highly appreciated capital gain property. The trustee of the trust (who is often the grantor) immediately sells the appreciated property in the trust and reinvests the proceeds in more diversified investments. CRTs also provide an immediate charitable income tax deduction equal to the present value of the remainder interest that is designated for charity. The trust does not pay any income tax on the gain realized from the sale of the appreciated asset, but that liability is captured in the trust and is carried out to the grantor as distributions are made. The annual income paid by the trust is either a fixed percentage of the trust's initial value or a fixed percentage of the trust's value determined on an annual basis. At the end of the trust term, the remaining trust property is passed to the named charity or charities, which can be changed along the way.

CRTs are popular tax planning vehicles because they allow taxpayers to capture at least some part of the economic value of an appreciated asset with no immediate income tax cost (e.g. the tax is deferred until the annual income streams are paid to the grantor). In many cases, the complexity and cost of setting up the CRT and administering it each year outweigh the benefits CRTs provide, especially for donors whose primary motivation in establishing the CRT is the deferral of tax on the sale of a concentrated position.

For many clients interested in diversifying a highly appreciated asset and also making a gift to charity, it is usually better to give the desired portion of the appreciated investment directly to charity, sell the remaining position in the investment (and pay the resulting long-term capital gains tax), and then reinvest the after-tax sales proceeds in a diversified portfolio. If you don't have a substantial charitable intention behind all of this, the CRT approach is often far too much trouble.

CLTs are similar to CRTs, but the annual payment stream is paid to the named charity or charities and the remaining property interest is returned to the grantor or to other named beneficiaries at the end of the trusts' term. If the grantor is the remainder beneficiary, which is a structure we don't generally recommend, he/she can take a charitable deduction in the year the trust is funded equal to the present value of the annual gifts made to charity by the trust, but must pay tax on the income generated by the trust each year. If the ultimate beneficiary is someone other than the grantor, the present value of the annual gifts to charity instead reduces the transfer value of the property for gift tax purposes and the trust pays tax on the income each year, offset by the deduction for the annual gift of income that the trust makes to the named charity.

CLTs are best used for charitable giving in one of two situations. The first is when the donor earns a lot of income in one year and wants to collapse several years' worth of charitable deductions into the high income tax year...though donor advised funds, mentioned above, also provide this result in a less complicated manner. CLTs are also useful to avoid taxable income (e.g. the income generated by the property transferred into the trust) by diverting it to charity when the donor intends to *eventually* pass property to other beneficiaries (usually children and/or grandchildren). The latter situation works particularly well in the situation where the grantor couldn't otherwise benefit from taking the charitable deductions him- or herself because they would continually exceed the annual charitable deduction limitations.

New Charitable Giving Opportunities

The government is currently examining new ways to allow taxpayers to support charities. One proposal would allow taxpayers ages 65 and older to make gifts *directly* to charity from their IRA accounts. Under current law, a person must first take a taxable distribution from the IRA before passing the assets to charity. Accordingly, if this proposal passes, certain taxpayers would have an opportunity to benefit charities while avoiding ordinary income tax rates on distributions from IRAs. Our fingers are crossed that this proposal makes it way through the legislative process, as it would provide further planning and charitable giving opportunities for many of our clients. It would be even better if the age restriction were lowered or removed altogether.

Americans are, by far, more generous with their money than any other society in the world. The wide variety of charitable giving options we have reflects this strong culture of philanthropy. Let us help you craft a strategy that optimizes your specific philanthropic objectives within the context of your particular income and asset situation.

*Sandi Bragar and
Greg Schick*

Staff Announcement

We are pleased to announce that Andy Hamilton has been promoted to Senior Investment Operations Specialist after a year and a half of great contributions at Kochis Fitz. In addition, Andy was married to Echo Nave on June 26th - congratulations to the newlyweds!

We also have two new members on our Investment Operations team, Jessica O'Leary and Nathan Wong.

Jessica joined the firm on June 1st as an Investment Operations Specialist. She has several years of experience in the financial services industry, including seven years at Charles Schwab & Co., Inc.

Nathan Wong became a part of our team on July 1st. He graduated from the University of San Francisco in 2003 with a Bachelor of Science degree in International Business. He has work experience in insurance and banking, working in the Credit Compliance and Risk Department at United Commercial Bank.

*Young S. Kim, Manager
Investment Operations*

Portfolio Rebalancing and Re-weighting of International Small Cap

During June we conducted our annual rebalancing process--adjusting each client's portfolio back to the target asset allocation of the client's investment plan. While disciplined adherence to asset allocation is a big driver of investment performance, there is a growing body of research showing that, in the case of rebalancing, less is more. This is due, in part, to the fact that, absent cash flows into or required withdraws from a portfolio, rebalancing trades can invoke otherwise avoidable taxes and transaction costs, reducing the potential benefit. Still, letting winning asset classes ride too long and asset classes that are relative losers go underfunded too long can be a recipe for portfolio pain as asset class dominance shifts. That it will shift is certain; when, of course, no one can be sure. Consequently we focus on curing developing imbalances annually...but not more frequently than that, and we continue to refine our trading rules to increase the likelihood of beneficial outcomes for rebalancing. Ultimately, we weigh the benefits of any rebalancing trades against any incremental tax and transactions costs for each client portfolio.

This year our rebalancing process coincided with a general change in the weighting of clients' developed overseas allocation between large capitalization stocks and small capitalization stocks. We previewed this change in our 1st Quarterly Commentary in April. In the past, we had divided most clients' overseas allocations 80% to large cap and 20% to small cap stocks. Our new division, 60% large cap and 40% small cap stock, is both more consistent with the large cap/ small cap relationship in domestic equities and reflects increasing evidence that small cap stocks overseas do enjoy a performance advantage.

We have long believed that the premium available domestically from small cap stocks versus large caps should also be available overseas. But the overseas small cap stock asset class is still *relatively* new and the risk/reward ratios have not been well documented until recently. During our recent review of capital market expectations, we found more research supporting the existence of a small cap premium overseas, with risk levels similar to those in the US. We are now even more confident than ever in the value of small cap investing overseas. In last quarter's Commentary, we presented our updated capital market expectations and showed the domestic small cap premium at 175 basis points above large (i.e. we expect small cap stocks to return 1.75% above the return from large cap stocks). In affirming the expectation of earning the small cap premium overseas, we estimate it at the same rate or 1.75% above the return on large cap stocks overseas.

For accounts where this 80/20 to 60/40 rebalance could be achieved without tax consequences (for example, in an IRA), the change was implemented rapidly. Taxable accounts required a bit more work. Using the 175 basis point premium estimate, we calculated the minimum rate of return expectation to justify selling current overseas large cap positions at a gain and buying overseas small cap stocks with the proceeds. Even at the highest actual gains

exposure in clients' portfolios and considering the minimum long-term capital gains holding period for the performance of the proceeds, the minimum required rate of return advantage was only 1.38% or 138 basis points. Consequently, it made sense to make the move in all cases where the large cap funds had been held for at least one year. In almost all other cases, we determined that it would be best to wait until the current holding period reached 12 months and then do the rebalancing trades.

Implementation of clients' investment plans involves division of portfolios into various asset classes and, then, sub-asset classes. In the rebalancing process, the first screening is done at the asset class level (large cap domestic, small cap overseas, etc.). If these are within the investment plan's tolerable limits, the process often stops there. The sub-asset classes ("growth", "value", "blend") are important, but the benefit of rebalancing over its costs is not as clear at this level. And, although we often have more than one manager in an asset class, as a general rule we did not attempt to rigorously equalize the allocation to each manager.

We, of course, took into account the size of the trades and the impact of any transaction fees (often having to weigh fees on both the sale and the purchase). We set a total of 40 basis points as the cut-off for tolerable transactions costs. As a result, we have postponed transactions for some of our smaller portfolios, awaiting any new portfolio inflows to facilitate coming back toward target allocations.

We will complete the annual rebalancing process in August when we address the allocations within the many Section 529 education plans clients began to establish in recent years.

Kacy Gott

A New World for Healthcare

In addition to the presidential candidates' divergent views of appropriate healthcare solutions, Congress recently passed very far-reaching legislation expanding Medicare drug coverage. We plan to discuss some of the key planning impacts for our clients in an upcoming issue of this Commentary.

Manager Watch

This quarter we are focusing on the two managers we use to gain “value-oriented” exposure in domestic large capitalization stocks: Berkshire Hathaway and DFA US Large Cap Value (in tax-exempt or tax-deferred accounts) or DFA US Tax-Managed Marketwide Value (in taxable accounts). We generally allocate 40% of a client’s overall domestic large cap allocation to these two managers, with 10% going to Berkshire and 30% to one of the DFA choices. We place the other 60% in an index fund, an ETF, or a tax-managed separate account that tracks the S&P 500.

BERKSHIRE HATHAWAY

Investment Strategy and Process

Warren Buffett, the CEO of Berkshire Hathaway, remains arguably the most successful long-term investor who ever lived. Under his leadership, and that of his longtime partner Charlie Munger, Berkshire has consistently produced strong gains in shareholder value. In Berkshire’s annual report, Buffett displays the per share gain in book value as a rough proxy for gains in intrinsic value. From 1965 (almost 40!! years ago), when Buffett took over Berkshire, to 2003, per share book value has grown from \$19 to \$50,498, a rate of 22.2% compounded annually, and Barron’s reports that the stock price has appreciated 5,000 fold. Moreover, the consistency of performance has been remarkable. Over the last 39 years, Berkshire has returned less than the S&P 500 only five times. Curiously, the last two annual periods of underperformance (2003 and 1999) have coincided with our reporting on Berkshire in this Commentary. Be advised that we may not report on Berkshire again!

The graph below shows that since we first invested in Berkshire back in 1996 the shares have handily outperformed the S&P 500, 15.1% versus 8.3%.



Meanwhile, as we observed in our 3rd quarter Commentary back in 1999, Berkshire has evolved into a conglomerate

with a heavy emphasis on insurance companies. A big benefit of these operations is “float”: cash that will eventually be paid out as claims to policyholders, but that is available, temporarily, to invest. The amount of float generated by Berkshire in 2003 was a staggering \$44 billion, double the amount produced in 1998 before the acquisition of the large reinsurer, General Re. Better yet, the float was acquired without cost because the insurance operations collectively produced a \$1.7 billion underwriting profit, meaning Berkshire was *paid* to hang on to the money. Buffet also pronounced that General Re, which in prior years experienced losses due to problems in its underwriting and reserving disciplines, “is fixed.” The huge amount of float combined with a gusher of cash earnings from other businesses provides Berkshire with plenty of dry powder to pursue investment opportunities.

The large stream of cash is a manifestation of Buffet’s continuing success in fostering and institutionalizing a culture...across all of Berkshire’s many businesses... focused on improving operations and producing long-term gains in intrinsic business value. With \$31 billion of cash on hand at year-end 2003, Buffet is patiently waiting to deploy that cash toward the purchase of companies that meet his time-tested criteria for success: companies with favorable competitive positions, able and honest management, and a sensible purchase price. Recently, Buffet has found it more advantageous to execute this strategy by purchasing entire businesses rather than fractional stakes in publicly traded companies. But if stocks become cheaper than entire businesses, Buffet promises to “buy them aggressively”. One consequence of the focus on entire businesses is that Berkshire’s public equity holdings now account for a much lower percentage of the company’s net worth (114% in the 1980s versus 50% in 2003). Movements in the general stock markets now have less direct impact on Berkshire.

So what’s Buffet been buying? Two of the most recent purchases were Clayton Homes, a leader in the manufactured housing industry, and McLane, a distribution company that was spun off from Wal-Mart. Buffet has also nibbled around in fixed income, selectively buying junk bonds when the price is right, and interestingly, engaging in what he terms “opportunistic strategies in fixed income securities” using borrowed money, which sounds to us like leveraged fixed-income arbitrage. With bearish views of the dollar, which Buffett outlined last November in an article in Fortune, Warren entered the foreign currency market for the first time in 2002. He expanded those positions substantially in 2003. Buffett is betting big against the dollar, a view we are not uncomfortable sharing, to help hedge Berkshire’s cash position, and to reap substantial rewards if he is right on the dollar’s direction. In these respects, by using classic hedges of fixed income arbitrage and global macro strategies, Buffett is borrowing from the toolkit of “absolute return” managers (see 4th Quarter, 2003 Commentary).

Why We Like This Manager

We continue to think that Warren Buffett and Charlie Munger are two of the smartest, most rational, and most

disciplined allocators of capital anywhere. We are very confident they will continue to deploy capital wisely in opportunities that grow shareholder value and lead to attractive compounding in Berkshire's stock price. We won't be at all surprised to see Berkshire continue to outperform the S&P 500 over time. Buffett and Munger expect it. We are reasonably confident as well; but there are risks.

Buffet's success at installing and infusing all of Berkshire's subsidiary companies with owner-oriented compensation systems and cultural norms, plus a "let's make Warren proud" motivational focus, ensures that building shareholder value remains the *raison d'être* at Berkshire. Finally, Berkshire remains a very tax efficient investment structure with all returns provided to shareholders in the form of capital gains (or losses) and then only at sale. Consequently, so long as Warren Buffett remains actively involved at Berkshire, which, happily, he plans to do indefinitely, we intend to remain shareholders of this unique investment vehicle.

But what if Warren does not remain active or gets hit by the proverbial bus? Would Berkshire remain as attractive an investment without him? A great deal of attention has been focused on this succession question and we struggle with it ourselves. Buffett himself has even chimed in announcing in the 2003 shareholder letter that his successor(s) will come from four internal candidates, and that his role will be split in two with one person serving as CEO of Berkshire's many operating businesses, and another person serving as Chief Investment Officer. Happily, Berkshire has some splendid managerial talent and a wonderful collection of businesses, many with strong competitive advantages that should make Berkshire a solid, perhaps a superb, investment for years to come. Nevertheless, in our view, it's very hard to believe Berkshire could be as good without the Oracle of Omaha as with him.

You can't easily replace his combination of talents – a mathematical wizard with a near photographic memory, possessing encyclopedic knowledge of thousands of companies with the discipline, experience, and independent judgment to have consistently made many more good or great investment decisions than bad. The sheer scope of Buffett's "comfort zone" is pretty amazing—from purchasing entire firms after one conversation and a handshake, to opportunistically investing in currencies, commodities, and junk bonds, to engaging in many forms of arbitrage, to fearlessly making outsized bets in individual companies; he has done it all. Add to that Buffett's managerial skills that have motivated so many talented executives to continue working for him long after they were rich enough to retire and you have one of the most difficult to replace business talents on the planet. Lastly, Buffett's personal network and early...and sometimes exclusive...access to attractive opportunities based on his star power and reputation may be completely irreplaceable.

Consequently, while we would not rush to sell right away if something happened to Buffett, it's hard to imagine we could remain as durably committed from that point as we are now.

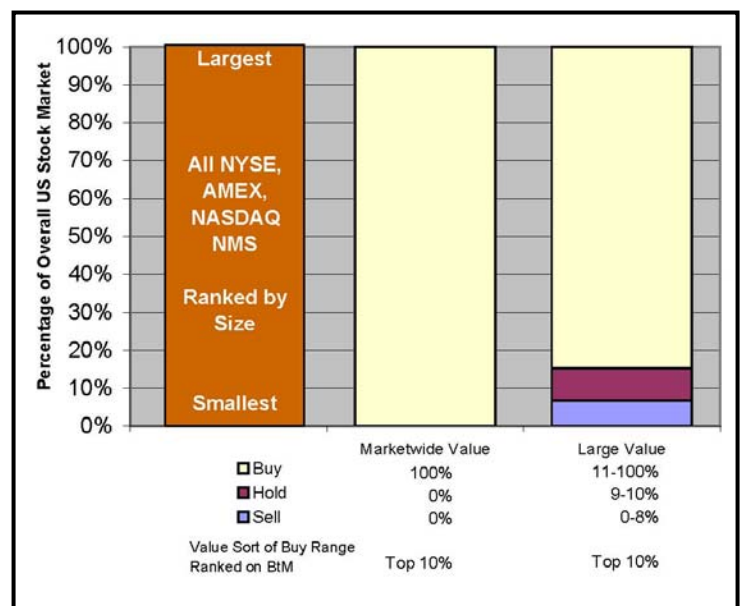
DFA US Large Cap Value and DFA US Tax-Managed Marketwide Value

Investment Strategy and Process

DFA US Large Cap Value ("DFA Large Value") and DFA US Tax-Managed Marketwide Value ("DFA Marketwide Value") provide targeted exposure to large cap stocks with value characteristics. DFA defines value in terms of high "book to market ratio" with a higher ratio indicating a more pure exposure to the value dimension of returns. This is important because DFA strongly believes (and empirical evidence supports) that markets are reasonably efficient and that excess returns, above what broad exposure to the entire market can offer, are a function of both *value* (distressed and/or low-priced companies) and *size* (small capitalization) effects. For DFA, three factors – market exposure, size exposure, and value exposure – largely explain stock returns.

The academics at DFA and elsewhere have *still* not completely satisfied themselves as to why the value or size effects have produced excess returns. It's conceivable that they never will. Believing in the efficiency of markets, academics tend to think that any opportunities for "excess" returns should be arbitrated away by profit maximizing investors. But the value and size effects seem to persist, so DFA has designed very tightly focused strategies to exploit them.

To get these exposures, DFA constructs portfolios using primarily a rules-based, largely mechanical process that strives to capture the specific return dimensions, market, size, and value, in a very low cost format that enhances returns through trading, low turnover, and low transaction costs. The graph below illustrates how stocks in the portfolio become available for purchase or sale based on prescribed buy, hold, and sell ranges as measured by size or book-to-market (BtM) ratio. Here, we deploy DFA's strategies to capture the value-effect in large cap stocks.



Why We Like This Manager

We think that DFA Large Value and DFA Marketwide Value are excellent vehicles to pair with Berkshire and a S&P 500 index-based exposure to obtain very low cost, structured, and reliable exposure to the optimized returns of one of the most efficient markets in the world—the market for domestic large cap stocks. As displayed in the first chart above, DFA Large Value has delivered by beating its benchmark, the Vanguard Value Index fund over time. Further, as we would expect, DFA Large Value has performed better versus its peers the *longer* the performance evaluation time frame. That's because the benefits of a passive approach in an

efficient market compound over time. The low cost, low turnover, structured design produces consistent performance, which while not expected to be spectacular in any one year, becomes *very good* over decades.

That does not mean that DFA Large Value is destined to beat *all* value managers over time. It won't. If only by chance, some manager will end up with a better record. The hard part is identifying that manager in advance and/or determining if it's more than just chance.

Tom Tracy

PERFORMANCE RESULTS

		2 nd Quarter 2004	12 Months to 06/30/04	3 Years Annualized to 06/30/04
Fixed Income				
<i>Short-Term (Taxable)</i>	Benchmark Index: Lehman Brothers 1-5 Year Gov/Corp Bond Benchmark Fund: Vanguard Short-term Bond Index	-1.8%	0.3%	4.5%
*	DFA Two Year Global Fixed Income	-1.2%	0.1%	3.4%
*	Scudder Preservation Plus Income	0.9%	4.8%	5.1%
	Vanguard Short-term Corporate	-1.3%	1.1%	4.4%
<i>Intermediate (Taxable)</i>	Benchmark Index: Lehman Brothers Aggregate Bond Benchmark Fund: Vanguard Total Bond Market Index	-2.5%	0.2%	5.5%
*	DFA Five Year Global Fixed Income	-3.3%	-1.1%	5.3%
*	PIMCO Total Return	-2.2%	1.1%	7.7%
	Merger	-1.0%	6.1%	1.7%
<i>Intermediate (Tax Free)</i>	Benchmark: Morningstar Muni CA Intermediate Category Avg. Vanguard CA Insured Intermediate Tax-Exempt	-1.9%	0.1%	3.9%
		-2.0%	0.1%	4.8%
Real Estate				
	Benchmark Index: Morgan Stanley REIT Index Benchmark Fund: Vanguard REIT Index Fund	-6.0%	25.7%	14.7%
	Columbia Real Estate Equity	-4.0%	28.4%	13.9%
*	Prana Growth	N/A	N/A	N/A
Balanced				
	Benchmark Index: 60% Wilshire 5000 and 40% Lehman Brothers Aggregate Bond Benchmark Fund: Vanguard Balanced Index	-0.2%	12.3%	3.1%
	Dodge & Cox Balanced	-0.3%	19.0%	9.0%
	Vanguard Asset Allocation	0.1%	16.2%	2.9%
Absolute Return				
	Benchmark Index: S&P Hedge Fund Index Benchmark Fund: Rydex Sphinx	N/A	N/A	N/A
*	Ironwood Partners	0.7%	10.2%	8.4%
*	Lazard Alt. Strategies	-0.3%	6.2%	N/A
*	Lighthouse (On-Shore)	-0.7%	5.5%	6.7%
*	Lighthouse (Off-Shore)	-0.9%	4.7%	6.4%
*	Silver Creek	-0.1%	7.5%	7.9%
*	Treflie (On-Shore)	-0.7%	9.6%	5.6%
*	Treflie (Off-Shore)	-1.4%	8.4%	4.7%
*	Undiscovered Managers Multi-Strategy Fund	-0.7%	8.3%	N/A
Large Cap: Domestic				
<i>Index</i>	Benchmark Index: S&P 500 Benchmark Fund: Vanguard Index 500	1.7%	18.9%	-0.8%
	Schwab 1000	1.3%	19.0%	-0.3%
	Large Cap ETF (SPDR)/Index (Schwab S&P 500)	1.7%	18.9%	-0.9%
*	Tax Managed Index Separate Account (Parametric)	<i>Return based on individual client's portfolio</i>		
<i>Value Style</i>	Benchmark Index: S&P 500/BARRA Value Benchmark Fund: Vanguard Value Index Fund	1.6%	20.8%	-0.7%
	Berkshire Hathaway	1.1%	27.6%	10.5%
*	DFA Large Cap Value	1.8%	28.0%	4.8%
*	DFA Tax Managed Marketwide Value	2.0%	28.0%	-0.7%

Continued on Next Page

* Preferential Access Through Kochis Fitz

Sources: Information from sources that we believe to be reliable.

Returns are stated net of managers' fees, but before Kochis Fitz fees.

PERFORMANCE RESULTS

		2 nd Quarter 2004	12 Months to 06/30/04	3 Years Annualized to 06/30/04
Large Cap: Developed Overseas				
<i>Growth Style</i> Benchmark Index: MSCI EAFE Growth				
	Benchmark Fund: Vanguard Total International Stock Fund	-0.4%	32.9%	4.5%
	Artisan International	-1.3%	28.0%	1.1%
<hr style="border-top: 1px dashed black;"/>				
<i>Value Style</i> Benchmark Index: MSCI EAFE Value				
	Benchmark Fund: Vanguard Total International Stock Fund	-0.4%	32.90	4.5%
	Longleaf Partners International	-0.2%	30.60%	6.3%
<hr/>				
Small Cap: Domestic				
<i>Blend</i> Benchmark Index: Russell 2000				
	Benchmark Fund: Vanguard Small Cap Index Fund	1.0%	34.4%	6.3%
*	DFA Tax Managed US Small Cap	0.3%	36.6%	7.1%
*	DFA US Small Cap	1.2%	35.7%	8.8%
*	DFA US Micro Cap	0.1%	40.1%	14.1%
<hr style="border-top: 1px dashed black;"/>				
<i>Value Style</i> Benchmark Index: S&P Small Cap 600/BARRA Value				
	Benchmark Fund: Vanguard Small Cap Value Index Fund	0.9%	35.0%	8.80%
*	Laudus Rosenberg US Small Cap Institutional	1.3%	35.5%	13.0%
*	DFA Tax Managed US Small Cap Value	1.5%	42.6%	11.4%
*	DFA US Small Cap Value	3.7%	50.1%	17.0%
*	Longleaf Partners Small Cap [Closed]	3.6%	25.9%	11.9%
<hr/>				
Small Cap: Developed Overseas				
	Benchmark Fund: DFA International Small Company Portfolio	0.4%	46.1%	17.7%
*	DFA International Small Company	0.4%	46.1%	17.7%
*	DFA International Small Cap Value	-0.1%	49.0%	22.0%
<hr/>				
Emerging Markets				
Benchmark Index: MSCI Emerging Markets Free				
	Benchmark Fund: Vanguard Emerging Markets Index Fund	-8.8%	34.2%	12.0%
*	Brookdale Global Opportunity Fund	3.17%	40.3%	21.3%
*	Oppenheimer Developing Markets	-4.7%	41.8%	15.3%
*	SSgA Emerging Markets	-10.4%	32.0%	11.9%
	T. Rowe Price Emerging Markets	-9.0%	34.4%	11.8%

* Preferential Access Through Kochis Fitz

Sources: Information from sources that we believe to be reliable.

Returns are stated net of managers' fees, but before Kochis Fitz fees.