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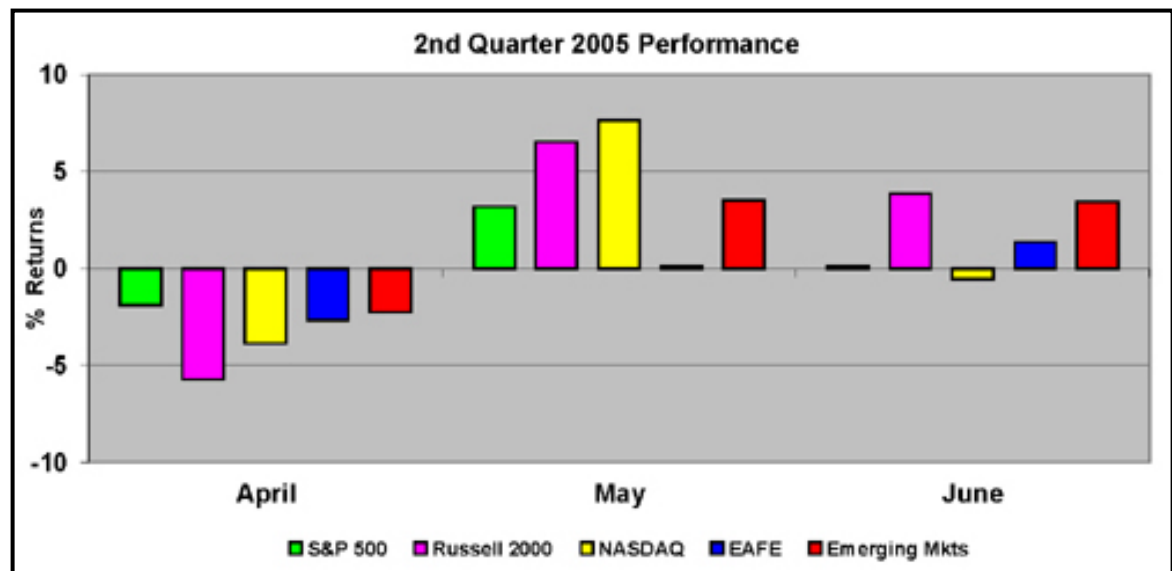
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Eking-Out Small Gains

Most clients' portfolios enjoyed modest gains during the second quarter, reflecting weak performance in April, a solid comeback in May and the first part of June, followed by big drops in June's final week. Small cap stocks, one of the weaker asset classes in the first quarter, were "best-in-show" this time around. Mike Fitzhugh's article below on our recent portfolio rebalancing activity describes our efforts to capture (over the long term) the benefits of this kind of asset class performance change.



Despite the discomfort produced by spiking (and then retreating) and respiking (and then again, retreating) oil prices, economic fundamentals are strong and looking stronger. Consumer confidence is up, unemployment is down, GDP growth for the 1st quarter was adjusted upward to a 3.8% annual rate, and inflation remains tame. There's good reason to believe that more good performance is to come. Business spending, slow to rebound from the market downturn of the recent past, is now coming increasingly on line, adding to the consumer spending impact. The slow pick-up in employment of 2003 and early 2004 many now have a silver lining in the form of increased productivity as more capital was invested per employee during that slow-to-hire era. Who knows for sure? Still, there seems little grounds for pessimism now that hiring has also picked-up.

As expected, the Federal Reserve raised short-term interest rates another 0.25% at the very end of the quarter. No surprise there. What disappointed many market participants was the absence of any change in the Fed's tune. Many were hoping for a clue that the rate increases were about to cease. Frankly we're not sure how that would be especially good news if it signaled a weakening of the economic fundamentals. Balancing the competing factors is a delicate and elaborate dance; thus far, Alan Greenspan and colleagues seem not to have missed a step.

In the article that follows, our CIO, Jason Thomas, discusses some of the longer range implications of the current interest rate scenario and also how the dollar's performance can be expected to impact portfolio returns.

This quarter, the dollar was up 7.0% against the Euro, as the EU exposed some of its structural discord on top of its generally weak economic performance. Still, clients' investments in developing economies overseas are producing respectable returns through the first half of 2005.

A Real Estate Bubble?

That is the question of the hour...for clients, and especially, the media. Some commentators are convinced that a bursting is virtually certain and imminent. If so, the impacts could be severe, both on direct real estate assets and other portfolio positions as well because of real estate's many and extensive second and third level impacts. But, we're not so sure. The still low interest rate environment remains very supportive, and numerous unique tax benefits apply to real estate. Its very illiquidity makes a bursting unlikely; at most, a slow deflating may be in store. Moreover, the phenomenon of substantial increases in residential real estate values is global. In fact, the run-up in home prices in both Australia and the UK was considerably larger than in the US, creating a bigger housing "bubble" which was potentially even more vulnerable to collapse. These increases are found especially in locales attractive to the world's mobile rich, and, probably for similar reasons, are not so pronounced in some less desirable areas. The law of supply and demand does not seem to have been repealed. In the most desirable locations, there is great demand and not so much supply.

Nevertheless, as a hedging measure, we believe that where clients do make real estate investments beyond their personal residence(s), they should focus on categories (commercial/industrial/multi-family rental) and geographies that provide some diversification, just in case. Further, as Kacy Gott and Andy Hamilton discuss in a following article, reducing the long term cost of financing a real estate purchase is always a smart idea. Returns will be what they will be, you have no real control over that part of the equation. You can, however, control a large part of the cost.

Meanwhile, our best guess is that rather than a "crash" (15% - 20%(?) declines in average prices), the more likely outcome is a slowing down in the rate of increase. Short-term rates in both Australia and the UK were considerably higher than current US short-term rates when housing activity there began to slow in the first half of 2004. Even though both central banks even raised short-term rates a bit higher, the weakness in housing activity has not led to a collapse in home prices. Instead, in both countries, there are signs that housing turnover and home prices have stabilized.

While there is a lot of room between the prospective outcomes of crash and merely slower positive growth, we believe clients' real estate holdings are likely to be quite safe over the longer term so long as they can afford the illiquidity in the event of a nasty short-term.

Tim Kochis, Editor

From The Chief Investment Officer

European Politics and the Dollar

The EU referendum in France and the Netherlands turned out to be a major catalyst for currency markets. In the months ahead of the referendum, the markets seemed to be thinking that the economic implications of the EU constitution, whether rejected or not, would be small. However, immediately after the first exit polls in France, it became clear that the outcome was a major blow for the process of political integration in Europe and (more importantly) it exposed a polarization of continental European voters with regard to domestic reforms. The results of the German regional election as well as the French and Dutch referenda highlighted that parts of the Euroland population are not prepared to tolerate the hardships generated by the reform process. Others sectors of the population still support the "short term pain for long-term gains" to improve the longer term outlook for growth and employment. In the struggle between these two camps the current French, Italian and German governments have been significantly weakened. The common perception in financial markets is that the reform progress will likely slow – at least in the near term – and therefore economic growth will continue to disappoint.

This political uncertainty and the relative economic weakness in Europe, as well as the continued willingness of the Asian economies (particularly China) to purchase *dollar*-denominated investments, caused the dollar to appreciate. In addition, recent domestic economic data suggest that the dollar may continue to strengthen. Greenspan's speech to the Joint Economic Committee and subsequent comments suggested that the Fed will continue to raise rates at the next few FOMC meetings. The June 30 meeting yielded the ninth such increase, a quarter percent, to a Fed funds rate of 3.25%, from only 1% a year ago. First quarter 2005 GDP was revised upward a second time to 3.8%, while inflation remained tame.

Nevertheless, this near-term market sentiment is not inconsistent with our longstanding view that the dollar will ultimately need to weaken further on a broad, trade-weighted basis over the medium- to longer-term. All markets are driven by a multitude of short-term (e.g., supply and demand) and long-term (equilibrium) factors. Among large, liquid financial markets, the global currency market is unusually resistant to equilibrium forces due to the presence of very large market participants who may not always be profit-maximizing (e.g., central banks). This causes market trends to be very long and makes forecasting the timing of exchange rate movements even more challenging. Clients therefore will benefit from the diversification of currency exposure built into their portfolio allocations.

The Interest Rate "Conundrum"

On May 31, the yield on ten-year Treasuries dipped below 4% for the first time since early February and the debate over bond yields, which began in February when Fed

Chairman Greenspan called the level of rates a "conundrum," has gained momentum.

There are two different, but related, topics of discussion. The first is the general level of bond yields. These are already low by recent standards – in the U.S., lower than the rate of economic growth (which many economists think they should roughly match). The second is the shape of the yield curve, the relationship between yields on Treasury securities of varying maturities. The curve is flattening: less than half a percentage point separates the yield on ten-year Treasuries from that on two-years, down from more than two percentage points a year ago. This is a global phenomenon – the curve is even flatter in Britain and Australia, and inverted in New Zealand.

The analysis of bond yields and the shape of the yield curve is complicated by the dual role of yields: they both affect economic performance directly and also reflect the market's expectations of the future. Rates may be low and curves flat because inflation is currently low and expected to remain that way, or rather because economic activity is expected to decline.

In a new paper by Hong Kong Shanghai Banking Corporation (HSBC), Stephen King notes that economists have generally done a poor job of forecasting yields. Focused on determining "neutral" or "equilibrium" interest rates (sufficient to achieve price stability in the first instance and balance savings and investment in the second), many have concluded that bond yields should approximate nominal GDP growth rates over time. But historically, the relationship between bond yields and GDP growth has not been stable. In the 1950s and early 1960s, a time of relatively low inflation and robust economic activity, yields were well below nominal GDP growth rates. Through the 1970s, unexpected inflation and sluggish economic performance caused losses for bond holders as rates rose to far exceed GDP growth. And from 1980, hurt by that experience, investors demanded a premium for holding bonds. In the past two years, yields have again fallen below GDP growth. Could we be moving back into that much earlier pattern?

Mr. King thinks we are, even though the world looks very different now. He predicts that the yield on ten year notes will fall to 3.5% in 2006 and so does Stephen Roach, chief economist of Morgan Stanley. But why? US economic growth still looks strong, its fiscal deficit predicts continued high borrowing, its trade deficit implies an eventual weakening of the dollar and high oil prices suggest inflationary pressure – all of these would normally push bond yields up! Greater mobility of capital and labor, plus the new prominence of low-cost India and China in world trade, has dampened inflation. To support this new trading order, Asian central banks are content, for the time being, to buy dollar bonds with their savings. The world's aging workforce is another support for bonds, as investors retire and at least gradually switch from growth securities into more stable, income-oriented securities. Central bankers have shaken off overt political control and are seen as invincible inflation fighters so the fear of any serious inflation is nowhere to be found. HSBC thinks that a number of these changes are

more or less permanent, and that interest rates around the world are likely to remain low for a long while.

While we are not in complete agreement with the view that low rates and, in particular, a flat yield curve are here to stay, we must acknowledge some strong arguments that rates may stay low for longer than many economists and market commentators expect. Sustained low interest rates and a flattish yield curve would have important implications for investment returns, favoring cash and equities (including private equity) at the expense of longer-term fixed income and hedge (absolute return) funds, broadly defined. We have never been big fans of long maturity fixed income investments and our appetite for absolute return vehicles may need to be even more cautious than before.

The Future of Hedge Fund Returns

Aside from the fourth quarter of last year (when hedge funds in general benefited from a strong U.S. equity market), hedge funds have not delivered outstanding performance over the last few years. The debate in the media about whether this is an anomaly (returns have been hurt by the low level of short-term interest rates and low market volatility) or is indicative of a lower-return future ("the beginning of the end" of superior returns) misses an important element – hedge funds are not above the laws of active management.

In the long-only equity world, most sophisticated investors understand very clearly that, to the extent that index funds and active managers hold all of the stocks in an index, active managers *as a group* cannot beat the index...because they ARE the index. For one active manager to win (outperform the index), someone else must lose (underperform the index). Taking management fees and trading costs into account, managers *as a group* MUST underperform.

However, when it comes to hedge funds, some participants seem to think that there is some magic being performed and that the fancy securities and strategies which hedge funds are using can add value without any connection to the "market." We must remember that value is created by the labor of people and the business operations of companies (a gross simplification of what economists call the "real" economy) and that the role of securities is to facilitate that value creation by allowing efficient participation. Derivatives of swaps...packaged as options...hedged by futures...etc. (you get the picture) can only increase the facilitation element - there is no direct value created. Hedge fund strategies can only produce return in excess of the risk-free rate, in aggregate, in one or both of two ways. They can provide exposure to the real economy (in practice often magnified through leverage) or they can increase the efficiency of capital movement and facilitate economic exchange. Once substantially all of the gains in efficiency are achieved, we would be back to the zero sum game of long-only managers and can only win if we can outwit another (usually sophisticated) market participant. This is the state of affairs in the convertible bond market, for example, where an estimated 80% or more of the bonds are held by hedge funds who trade them back and forth.

Despite the protests of some fund of hedge fund managers, it seems clear that there are too many hedge funds and too many dollars to be profitably invested over the long run. We may already be seeing the beginning of a rationalization of the industry with the highly publicized closing of two hedge funds: Bailey Coats and Marin Capital. While the closing of additional funds would be painful for their investors, it may be an important step to ensuring the health of the industry. We continue to monitor developments in the hedge fund world, watching for signs that our core absolute return managers may be suffering, and we are continuing to look for managers who have unique and defensible strategies.

Jason Thomas, PhD.

Important Regulatory/Legislative Updates

As part of our ongoing planning work for clients, we are keeping an eye on relevant changes in the planning environment. Here are a few current developments.

Section 529 Plans: A move to stop the sunset!

"The College 529 InvEST Act of 2005" (Investment in Education Savings for Tomorrow) consists of two bills circulating in the Senate and House of Representatives that make permanent the provisions for tax-free growth and spending for qualified higher education expenses. Current law calls for a sunset of favorable tax treatment in 2011.

Kochis Fitz has championed tax-free §529 plans for education funding since legislation passed in 2001 and have predicted that the tax advantages would be made permanent. These plans are very broadly recognized as one of the best investment opportunities for post secondary education. At the end of the first quarter, assets in excess of \$55 billion had been invested in § 529 plans, and this number is expected to climb to \$200 billion by 2008. Given the popularity of this savings tool, we believe that members of Congress will find it difficult, if not impossible, to vote against repealing the sunset. So, not only are existing §529 plans safe, but the path seems about to be clear for much more of this opportunity.

Estate Tax. Reform or Repeal?

Again in April 2005, the House voted to permanently repeal the estate tax in 2010; the decision-making process has now moved to the Senate. Supporters of a permanent repeal, including President Bush, denounce the estate tax as an unfair punishment of the wealthy and a double taxation of life-time earnings. Opponents to the bill consider it an unfair break for the wealthy at a time when federal deficits have soared. A compromise would likely involve some trade off of rates and/or exemption relief in exchange for retaining *some* version of the tax. For example, Senator Jon Kyl (R) suggests a \$10 million per person exemption and a 15% estate tax rate (equal to the current federal capital gains rate). Senator Max Baucus (D) wants a *higher* rate, but with

a personal exemption between \$3-5 million instead of the current \$1.5 million.

How many individuals could this impact? In 2003, 20,600 estate tax returns were filed with the IRS for estates worth more than \$1 million. Of those, just 3,486 were estates worth \$5 million or more. In 2004, it's estimated that 19,000 estates owed estate tax with an average tax bill of \$935,000, or a total of \$17.6 billion. Over the next twenty years, it's estimated that a repeal could reduce federal revenue by \$1 trillion! Lawmakers who favor a compromise claim that a total repeal would be too costly to the Treasury at a time of concern about the federal budget.

Arguments against a permanent and total repeal have also been voiced by charitable organizations. Without an estate tax, they claim, there is less incentive for the wealthiest Americans to make charitable bequests through their estate. A repeal could result in as much as a \$10 billion loss in annual charitable giving. Responsible Wealth, a coalition of business leaders with a membership among the nation's wealthiest five percent that includes Bill Gates, Sr. and Warren Buffet, claim the estate tax is our most progressive tax and an important source of revenue. And importantly, it serves as an "incentive to recycle wealth through the nonprofit sector." Still, these commentators seem to miss the point that both charities and donors can often do better through gifts made during the donors' lifetime. Such gifts also, of course, reduce the estate size and produce current *income* tax savings that can be more valuable than eventual estate tax savings; and the benefits to charity come sooner rather than later.

Basis Step-up

There is also a less publicized potential repeal of the step-up in basis rules. Currently, an heir's tax basis is either the more favorable of the fair market value of the assets on the date of death, or the fair market value six months after the date of death. This long-standing arrangement for step-up in basis continues through 2009, undergoes major changes in 2010, and comes back in 2011. In 2010, not all appreciated assets in the estate will receive a basis step-up. Those not adjusted would be subject, at sale, to capital gains taxes for any appreciation from the decedent's original cost. Some proposals would make that arrangement apply to *all* assets. Kochis Fitz believes that it's unlikely that this provision will survive as it would create an accounting nightmare. It was tried once before, in 1976, and was almost immediately repealed.

There will undoubtedly be more arguments from both sides of the aisle before a compromise on estate tax reform or repeal is reached in the Senate. There is, however, large bipartisan support to establish some permanent change to our existing estate tax legislation and the consensus is that changes will be made in 2005. For good or ill, we think full repeal is very unlikely, but some form of reform will likely benefit our clients. For now, we are recommending that clients not make major, non-dispositive revisions to estate plan documents until the outcome of pending legislation is more certain.

Non-Profit Transparency

In June of this year, the Panel on the Nonprofit Sector, an advocacy group representing charities, foundations, and other recipients of large donations, offered the Senate Finance Committee a report that includes over one hundred suggestions on how to begin reform of the nonprofit sector to curtail abuses by tax-exempt entities and their donors. Diana Aviv, executive director of the Panel, says the “[nonprofit] sector has exploded in size and diversity” and that at the same time “current law has not kept up.” Aviv maintains that increased transparency is the key reform.

Simultaneously, the Senate Finance Committee has been pushing for broad tightening of the rules on the behavior of charities. The IRS estimates that there is a \$15-18 billion tax gap due to an overstatement of deductions but hasn't identified the portion attributable to *charitable* deductions. While Committee members support the reform, they're recommending a cautious approach so as not to discourage legitimate charitable donations.

Many of the Panel's suggestions deal specifically with “donor-advised funds” (DAF's), like those that we have encouraged many of our clients to establish. The donor contributes appreciated assets or cash and immediately receives a tax deduction for the value of the contribution at the time of transfer. Account owners direct the investment of the assets contributed to the account, and enjoy the flexibility to direct nominations to tax-exempt charities of their choice, when they choose to do so.

Due to reported abuses of the tax deduction on DAF contributions, the Panel's report calls for the IRS to adopt a specific definition of a donor-advised fund and urges new rules that require distribution of at least five percent of assets annually, written agreements between the fund and receiving charities, prohibitions on donations from the funds to private foundations or to the fund's donors, and minimum activity rules for individual accounts. None of this would impose a serious burden on our clients' use of these arrangements.

Kochis Fitz expects that any such legislation will have minimum impact on our clients since the custodians of our donor advised funds currently require written agreements and verify the non-profit status of charities before allowing grant nomination to be made. If minimum activity and distribution provisions are passed, we'll assist clients in monitoring their accounts to verify that they meet the new guidelines.

CRT Waivers

Effective June 28, the IRS has imposed a requirement that Charitable Remainder Trusts have in place an effective waiver of rights by the donor's spouse. For newly established CRT's, the absence of a waiver would preclude the available tax deduction. This provision is designed to alleviate a problem that has occasionally arisen where the surviving spouse makes a successful claim against charitable trust assets that had previously produced a tax deduction for the now deceased donor spouse. A

remarriage, or a move to a state which may provide greater surviving spousal rights could require a new waiver to be in place. We will be in contact with all clients who have existing CRT's to make sure any appropriate waivers are in place.

New Constraints on Lump Sum Pension Payouts

Legislation is now under consideration in the House that would make the option of a lump sum payment of a defined benefit pension more difficult to obtain and, probably, smaller than would currently be calculated. Inadequately funded plans would not be permitted to offer lump sum payouts at all and the present value calculations of any lump sum would be required to use reference rates that would generally be higher than those in use today. Higher rates produce smaller lump sums.

*Sarah Bailey and
Jane Zaloudek*

Portfolio Rebalancing – Present and Future

The second quarter was a period of heightened activity in many clients' portfolios. As discussed in last quarter's *Commentary*, we began restructuring portfolios in April by replacing seven actively managed mutual funds. Separately, during this past quarter, we also undertook our annual rebalancing of client portfolios.

Although we monitor client portfolios on an ongoing basis, and rebalance along the way as clients add cash to, or make withdrawals from, their portfolios, once a year we comb through every portfolio to make sure each one is sufficiently close to its target asset allocation. Portfolio theory and empirical evidence suggest that rebalancing is a very important practice, and one that many investors either overlook or recoil from, since it often means selling one's winners and buying one's laggards. The main benefit to rebalancing comes from the tendency for asset class performance to “revert to the mean” after periods of especially good or especially poor performance. In a perfect world, rebalancing would allow you to harvest gains in one portion of the portfolio at the top of the market and reinvest the proceeds in another segment of the portfolio that has done poorly by comparison with the first, but which is about to turn around. In the real world, where peaks and troughs are apparent only in hindsight, periodic rebalancing still adds considerable value

There is a band around the target allocation within which we're willing to let the actual allocation wander without correction. While there are benefits to being “on target,” those benefits come at some cost in terms of taxes and transaction charges, which we seek to minimize. To balance those conflicting objectives, our current practice is to rebalance only if the actual allocation is more than 5% from the target (i.e., if the target for domestic large cap equity is 30%, we'll only rebalance if it is below 25% or above 35%).

Where the target allocation is less than 10%, our rebalancing range is plus or minus 50% of the target.

We also have targets for sub-asset classes (i.e. how much “value”; how much “growth”) and for specific funds (how much in fund x, or y, or z in a particular sub-asset class), but we allow increasingly greater tolerance at these portfolio levels. The correlation of returns between sub-asset classes within an asset class, and funds within a sub-asset class are relatively high, so the benefits of rebalancing are lower here than at the asset class level.

Advancing The State of The Art with “iRebal”

In the past, the annual rebalancing effort has been anticipated with about as much enthusiasm as one would muster for a tooth extraction. Looking at every portfolio and attempting to rebalance all the pieces while minimizing transaction costs and taxes, and while attempting to place tax-inefficient investments in tax-deferred accounts was not only tedious but so subject to error that it required multiple layers of review.

Over the past year, Kochis Fitz, in conjunction with two other wealth management firms, has developed an artificial intelligence tool to automate this process. Throughout the software design process, we compared notes on best practices with our peer firms and incorporated these into a program called iRebal, for “intelligent rebalancing.”

After being fed data on each client (tax rates, capital losses, etc.) and each portfolio (target asset allocation, special account limitations, idiosyncratic client preferences) over the prior 6 months, iRebal made its debut in our firm in April. Already, in release 1.0, it has produced several important benefits in more reliably consistent application of rebalancing criteria across portfolios, at much greater speed. Over time, as the software incorporates ever-more information, we expect that this will free up more of our firm’s resources for those client-specific portfolio issues and client service needs that we have no desire to automate.

The three firms that developed iRebal are also underwriting some groundbreaking research into the optimal *frequency* for rebalancing (monthly? annually?), the optimal bands around the asset class targets (bands that vary with the volatility of the asset class, for example, as opposed to a fixed, uniform band like our current 5%), and asset placement between taxable and tax-deferred accounts. We also hope to have this research be able to quantify the benefits (in terms of enhanced risk-adjusted rate of return) attributable to each of these constituent parts.

With the benefits of this research and an increasingly powerful iRebal, Kochis Fitz intends to remain at the forefront of the science and the art of managing portfolios for taxable individuals. However, no software tool we can presently envision will ever completely replace the insights of experienced wealth managers. Rest assured, while iRebal will aid our management efforts, your portfolio will continue to have our finger prints all over it.

Mike Fitzhugh

Still Time to Refinance?

Discussion of the current environment of mortgage rates and whether or when to refinance is a very frequent agenda item for our recent conversations with clients. Long-time readers of our *Wealth Management Commentary* know that it is also a frequent subject in these pages. In July 2002 we made our case for interest-only mortgages and argued the advantages of variable rate mortgages over fixed rate mortgages for clients willing and able to accept the risk. The April 2003 edition addressed the fact that variable rate mortgages still made sense even in light of expectations at that time of rising interest rates. Clients who took this advice (adopting interest only and adjustable rate mortgages) benefited greatly. Today, two to three years later, the short-term interest rate environment has changed much and many clients wonder if our thinking has changed as well.

For years, we have argued the merits of interest-only mortgages for our clients. To sum up the April 2002 article, as long as the after-tax cost of borrowing is less than the expected after-tax rate of return on portfolio investment, it makes sense to borrow (have a mortgage) and not pay it back (i.e. an interest-only mortgage). Even in the current environment of rising interest rates and lower investment return expectations, mortgage proceeds still provide very cheap investment leverage (2.5 to 3% after-tax interest costs versus high probability after-tax return expectations at or above 4.5%). Our thinking here remains unchanged.

What has Changed?

There have been several recent developments in the mortgage landscape that warrant attention. The first one is the shrinking additional charge (margin) over the base interest rate on 1-month LIBOR (London Inter-bank Offered Rate) loans. The second is the narrowing of the gap between fully adjustable variable rate mortgages and the hybrid variable, specifically the 5-year fixed rate mortgage (which converts into an adjustable mortgage after 5 years).

Lower Margins on 1-month LIBOR

While over the last few years we have seen margins in the 1.2% - 1.6% range, the best we’ve recently seen is a 1-month LIBOR loan margin of 0.85%. This means that by obtaining this loan today, you can generally lower your interest payments by 35-75 basis points (0.35-0.75%). Depending on the cost of moving to this new loan, it makes sense for many clients to get the new rate even if they already have an adjustable mortgage tied to the 1-month LIBOR.

There are two ways that this lower rate can be obtained. The preferable method is through modification of an existing loan. Loan modification, unlike a refinance, does not involve paying down the old loan and starting a new loan. It is simply a modification of the old loan terms. Modifications are significantly cheaper than refinances (generally about \$1,000, versus \$3,000 - \$4,000 for a refinance), but unfortunately are only available if the bank has not sold the original loan. Fortunately, 1-month LIBOR loans are the

ones that are most likely to still be “in house”. If it’s available, this is a no-brainer! The \$1,000 cost is recouped by the reduced interest on a \$1.1 million loan in at most 3 months.

If modification is not available, refinancing is your other option. While more expensive (about \$3,800 for a \$1.1 million mortgage assuming no prepayment penalties), refinancing can quickly pay off, given current margins. For example, if you were lucky enough to obtain a 1-month LIBOR loan with a 1.2% margin in the past, you could cover the refinancing costs within one year of refinancing to a 0.85% margin. Then, the savings continue to compound. If you are picking up more than a 0.35% margin reduction, the breakeven is quicker, and the savings are even greater.

Unfortunately when refinancing, your current mortgage may be subject to those pesky prepayment penalties. Prepayment penalties on 1-month LIBOR product that we researched (and which many of our clients have) are 1% of loan value for the first four years. However, the terms of these contracts typically permit you to pay down up to 20% of loan principal in any given year without penalty, so the effective penalty is 0.80% (\$8,800 on a \$1.1 million mortgage). This makes the decision to refinance a little muddy. However, even in a worst case (only a 35 basis points advantage), you can recover this cost plus refinance costs in under 3 ½ years. If you are reasonably confident of your holding the new loan longer than 3 ½ years, a refinance makes perfect sense.

Fully adjustable versus the Hybrid?

LIBOR-based loans are not the only adjustable loans in town. So called “hybrid adjustable mortgages” have also become increasingly popular. The majority of these loans are set at a spread (margin) to the one-year Treasury rate. The loan rate is fixed for a defined period of time, then adjusts according to the where the one-year treasury is when the fixed period is up. The most popular and competitively priced version is the 5-year fixed.

When we wrote about this in April 2003, the spread between 1-month LIBOR loans and 5-year fixed loans was 1.9%, with the LIBOR having the lower rate. As we go to press today, this spread has almost evaporated, narrowing to 0.5% for refinances (and a mere 0.3% for new purchases). In part, this is due to the flattening of the yield curve, as discussed in Jason Thomas’s article. Further, our recent survey of

expectations for the 1-month LIBOR came up with an average of 4.3 - 4.4% over the next 3-5 years, resulting in a rate of 5.15 to 5.25%, with the margin. This means that the 5-year fixed rate is currently *less* than where we think the 1-month LIBOR loans will be within a year, creating an enticing refinancing opportunity.

If we’re right about the extent of increase in the 1-month LIBOR rate, then refinancing to a 5-year fixed mortgage could be an even better move. Our analyses indicate that refinancing a \$1.1 million, 1-month LIBOR mortgage (even given a margin over LIBOR of only 0.85%) to a 5-year fixed pays off in about 2 years (maybe 3 years if prepayment penalties are involved). Once beyond the 2-3 year mark, the savings compound as you benefit from the fixed nature of the rate over the remainder of the five year period.

Still, probably not a permanent solution

Part of the price of these interest-only advantages is the need to re-evaluate the mortgage choice from time to time. Is this short-term uncertainty and periodic restructuring (whether 3 years, 5 years, or 10) worth it? We think it is! The alternative is a long term fixed *and* amortizing mortgage. Over time, the advantage of an interest-only mortgage for \$1.1 million could easily be \$20,000 (per year!) in after-tax net worth advantage.

*Kacy Gott and
Andy Hamilton*

Interest-only mortgages have received plenty of negative press lately by some in the media who claim that they create a “false sense of affordability” for many people. In other words, they have become the mortgage product of choice for people who cannot afford an amortizing loan. The media is correct in asserting that interest-only loans can be dangerous, but the risk is not in the loan product itself. The people who could be hurt by these mortgages are the ones who could not otherwise afford the home with an amortizing mortgage. Our clients do not fit this profile, and they should take advantage of the long-term financial benefits that interest-only mortgages offer.

PERFORMANCE RESULTS

		2 nd Quarter 2005	12 Months to 6/30/05	3 Years Annualized to 6/30/05
Fixed Income				
<i>Short-Term (Taxable)</i>	Benchmark Index: Lehman Brothers 1-5 Year Gov/Corp Bond			
	Benchmark Fund: Vanguard Short-term Bond Index	1.7%	2.8%	3.4%
*	DFA Two Year Global Fixed Income	1.1%	1.9%	2.2%
	Vanguard Short-term Investment Grade	1.6%	3.1%	3.7%
<i>Intermediate (Taxable)</i>	Benchmark Index: Lehman Brothers Aggregate Bond			
	Benchmark Fund: Vanguard Total Bond Market Index	3.0%	6.7%	5.4%
*	DFA Five Year Global Fixed Income	2.9%	5.6%	4.9%
*	PIMCO Total Return Institutional	3.2%	7.7%	6.6%
 <i>Intermediate (Tax Free)</i>				
	Benchmark: Morningstar Muni CA Intermediate Category Avg.	2.1%	5.3%	3.8%
	Vanguard CA Insured Intermediate Tax-Exempt	2.6%	5.7%	4.5%
Real Estate				
	Benchmark Index: Morgan Stanley REIT Index			
	Benchmark Fund: Vanguard REIT Index Fund	14.7%	32.2%	20.0%
	Columbia Real Estate Equity	10.3%	27.2%	19.4%
*	Prana Growth (performance updated bi-annually)	NA	NA	NA
Balanced				
	Benchmark Index: 60% Wilshire 5000 and 40% Lehman Brothers Aggregate Bond			
	Benchmark Fund: Vanguard Balanced Index	2.6%	7.8%	8.4%
	Dodge & Cox Balanced	1.1%	9.7%	11.3%
	Vanguard Asset Allocation	1.3%	7.8%	8.9%
Absolute Return				
	Benchmark Index: S&P Hedge Fund Index			
	Benchmark Fund: Rydex Sphinx	-0.5%	1.6%	NA
*	Ironwood Partners	0.4%	6.9%	9.4%
*	Lazard Alt. Strategies	-1.7%	2.3%	5.5%
*	Lighthouse Diversified, LP	1.2%	7.2%	7.0%
*	Silver Creek Low Vol 1	1.9%	12.0%	10.2%
*	Treffle Absolute	1.8%	10.4%	8.9%
*	Undiscovered Managers Multi-Strategy Fund	0.9%	4.4%	5.2%
Large Cap: Domestic				
<i>Index</i>	Benchmark Index: S&P 500			
	Benchmark Fund: Vanguard Index 500	1.3%	6.2%	8.2%
	Schwab S&P 500 Institutional Select	1.4%	6.4%	8.2%
	S&P 500 ETF (SPDR)	1.3%	6.2%	8.1%
*	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	1.7%	12.6%	10.5%
	Berkshire Hathaway B	-2.2%	-5.5%	7.0%
*	DFA Large Cap Value	2.8%	15.1%	11.7%
*	DFA Tax Managed Marketwide Value	3.0%	15.0%	12.8%

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 2005	12 Months to 6/30/05	3 Years Annualized to 6/30/05
Large Cap: Developed Overseas				
<i>Growth Style</i>	Benchmark Index: MSCI EAFE			
	Benchmark Fund: iShares MSCI EAFE	-1.1%	13.2%	11.8%
	Vanguard Total International Stock Fund	-0.7%	15.0%	13.0%
<hr/>				
<i>Value Style</i>	Benchmark Index: MSCI EAFE			
	Benchmark Fund: iShares MSCI EAFE	-1.2%	13.2%	11.8%
	DFA International Value	-1.4%	16.5%	17.0%
	DFA Tax-Managed International Value	-1.2%	16.1%	16.8%
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Small Cap: Domestic				
<i>Blend</i>	Benchmark Index: Russell 2000			
	Benchmark Fund: Vanguard Small Cap Index Fund	4.8%	12.3%	13.7%
*	DFA US Small Cap	4.0%	8.7%	14.3%
*	DFA US Micro Cap	3.9%	8.0%	16.0%
*	DFA Tax Managed US Small Cap	3.8%	9.5%	14.4%
<hr/>				
<i>Value Style</i>	Benchmark Index: S&P Small Cap 600/BARRA Value			
	Benchmark Fund: Vanguard Small Cap Value Index Fund	5.3%	16.3%	11.8%
*	DFA US Small Cap Value	3.0%	12.6%	18.0%
*	DFA Tax Managed US Small Cap Value	2.7%	12.0%	15.3%
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Small Cap: Developed Overseas				
	Benchmark Fund: Morgan Stanley Intl Small Cap A	-0.7%	17.5%	19.8%
*	DFA International Small Company	-1.6%	19.1%	24.1%
*	DFA International Small Cap Value	-1.1%	24.9%	28.8%
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Emerging Markets				
	Benchmark Index: MSCI Emerging Markets Free			
	Benchmark Fund: Vanguard Emerging Markets Index Fund	3.8%	34.9%	24.2%
*	Brookdale Global Opportunity Fund	1.7%	14.5%	19.1%
*	DFA Emerging Markets Core Equity Portfolio ¹	NA	NA	NA

* 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.

¹ Inception date 4/5/2005