

Capital Markets Commentary

For the quarter and year ended December 31, 2004

Welcome to FiduciaryVest, LLC's quarterly Capital Markets Review and Commentary.

This publication, now issued by our recently formed company, continues a 14- year string with the same editorial policies and narrative approach. We hope you will continue to find it informative and useful and that you will provide us your comments, challenges and criticisms.

This Volume I, number 1 issue by FiduciaryVest, LLC seems an appropriate occasion to re-state our editorial policies:

- 1. The mission of this publication is education; we believe education is distinct from information.*
- 2. Because its audience is broad, we will not include specific investment advice.*
- 3. Though we will include widely available market data, we will not typically focus our articles on it.*
- 4. Instead, we are committed to report and analyze global market, economic and political developments that we believe have a future impact; we will strive to connect the dots with that future.*
- 5. Because we believe the investment world generally takes itself too seriously, we will strive to create a mirror for the industry's trends, framed in mildly humorous critique.*
- 6. This publication will not editorialize about specific companies or people.*

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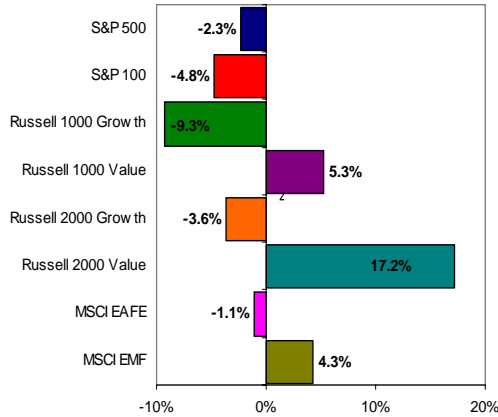
An Average Year for Stocks

Most common stock investors were delighted...and relieved to have the market move upward by 11 to 12 percent for 2004. After what they had endured since the millennium-turn of the calendar and up until the 2nd quarter of 2003, any double-digit figure on the positive side seemed extraordinary. But, if we consider the well-known historical data for the US stock market, realize this: Say you have to make a huge one-time, 12-month bet on the market's return; then, your highest probability bet will always be between 11 and 12 percent. It actually happens fairly frequently, even when the annual market dice are rolled as few as five times. Indeed, large company stocks had a compound, double-digit return in nearly 2/3 of the past 75 five-year periods, while their small company counterparts achieved that performance level in almost 3/4 of those periods. These will be facts to remember as we listen to arguments between Congressional factions posturing over the President's Social Security proposal for private accounts that would hold *real* investments.

Bad start for century 21

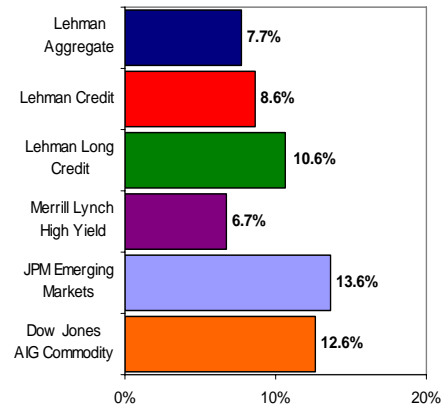
We are already halfway through the first decade of the 21st century and it is a supreme understatement to observe that most segments of the equity markets, including international stocks, are off to a weak start. Bonds, on the other hand, have performed well, because of a flight to safety and quality during the early years of this century. Lately, however, all types of equities have had strong returns, while a flight to yield (away from safety and quality) has caused the junkiest of bonds to produce high-octane total performance. Finally, after more than a decade of almost zero inflation coupled with extreme price weakness, commodities have been robust and the long-only commodities indexes beat all other domestic investment categories, except small cap value equities (which have uniquely surged throughout the entire five-year frame).

5 year returns - Equities



All returns shown are annualized

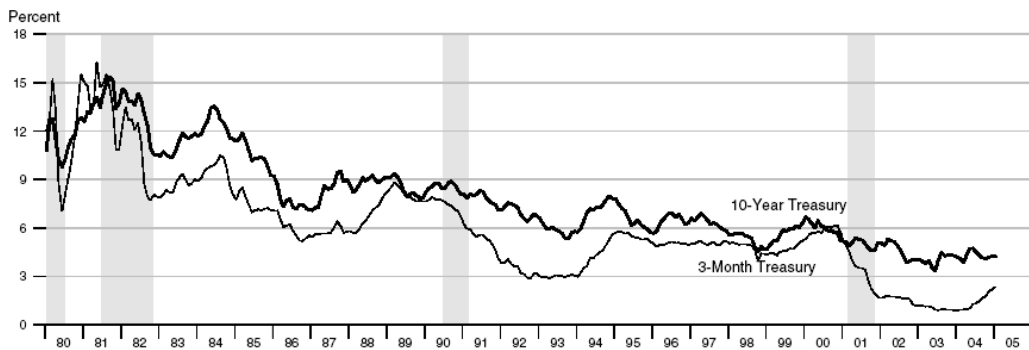
5 year returns - Fixed Income & Commodities



What next?

Periods of sustained rising interest rates will predictably chop away some of the average return, while long periods of falling rates will add to returns. The US has recently ended (apparently) a 20-year period of declining interest rates (see graph below). While there have been interest rate upticks, particularly in Fed-controlled short-term rates during that period, the secular downtrend is unmistakable. The 10-year Treasury note's yield went from 15-percent territory in 1982-83 to a bottom near 3 percent in 2003.

Interest Rates



Consequently, all investment asset valuations have seen robust times. Unfortunately, a trend period lasting as long as 20 years tends to set the expectations of both investors and consumers into a one-dimensional mode. The best current example is probably real estate, particularly single-family housing prices. Most Americans' largest investment is the tax shelter they call home. The constantly climbing value of everyone's castle has caused many to turn that paper wealth into cash, via home equity loans that are often used to pay off credit card debt and other consumption-based outlays.

The result has been to convert an appreciating asset into depreciation, or even into just plain expense money. This popular trend would be less than threatening to the future economic well being of most borrowers, if only they had locked in those 40-year-low long-term mortgage rates. But, nooooo. Instead, most of them opted for the ultimate in cheap money (for now)... adjustable rate mortgages and home equity lines of credit.

With Federal Reserve-driven rates at anti-depression "emergency" lows for much of the past four years, mortgage lenders promoted the adjustable instruments with abandon, in order to set their sails for more normal times. Unfortunately, many of those loans will literally come home to roost, as rates climb back to historically average levels or, worst case, even higher.

To observe that household debt is high and rising does not capture much of the story. After all, everything in the economy is going up. But, as a percentage of GDP, the story is truly amazing. From the early 1960s through the mid 1980s, American households were holding steady around 45 percent, but since then consumers' borrowings have literally soared.

By the end of the 20th Century, consumer debt had captured almost 70 percent of GNP and in the past four years their share has blossomed more than 10 additional percentage points. So, now more than four out of every five dollars of total domestic commerce involve consumer debt and homestead borrowings. As a result, guess what has happened to consumer savings.

Personal Saving Rate



The US Equity Market

Another year, another photo finish

The fourth quarter turned what had been a frustrating, directionless nine months into a satisfying year for the broad indexes. Down the stretch from the final quarter-pole, the market turned in about 4/5 of the year's total. It was a repeat performance from the final quarter of 2003 when we understood why; this time, we don't. Especially when, without provocation, sloppy returns returned, as soon as the calendar changed over to 2005.

	4Q	2004
S&P 500	9.2%	10.9%
Wilshire 5000	10.3	12.6
Russell 3000	10.2	12.0

Value beats growth again

For the past 1, 2, 3, 4...10 years, the value-style segment of the market beat out its growth cousins, both in the large cap and small cap categories. The race was not close.

	4Q	2004	3yrs*	5yrs*	10yrs*
Russell 1000 Growth	9.2%	6.3%	-0.2%	-9.3%	9.6%
Russell 1000 Value	10.4	16.5	8.6	5.2	13.8
Russell 2000 Growth	15.1	14.3	5.8	-3.5	7.1
Russell 2000 Value	13.2	22.3	16.5	17.3	15.2

Size still matters

There was a period in the 90s when mostly foreign investors, via index buying, and others seeking the biggest US company names, drove them to the top of the performance ladder for several years. But history and abundant logic tell us that the performance spread we have seen more recently is the one we should expect for most long runs periods.

	4Q	2004	3yrs*	5yrs*	10yrs*
Large - Russell 1000	9.8%	11.4%	4.3%	-1.8%	12.2%
Small - Russell 2000	14.1	18.3	11.5	6.7	11.5

*Periods longer than 12 months are annualized

The US Debt Market

How to raise interest rates without tripping the alarm

The Federal Reserve is taking the occasion of almost every meeting of its Open Markets Committee to ratchet short-term interest rate targets up another notch. In the old, secretive days, the investment industry press and bond portfolio managers used every possible device to try to anticipate what the Fed would do, if anything, about rates and when. After all, bond prices hung in limbo, awaiting the latest tea leaf readings of so-called "Fed Watchers". But, today we have a new, communicative Fed that likes to tell the world what its forward thinking is. No more stealth. No longer does the Fed try to purposely throw market makers off the track regarding its true intentions.

In the current situation, the US has the following major current inputs that will bear on the Fed committee members' minds, as they consider what to do with interest rate adjustments at every meeting:

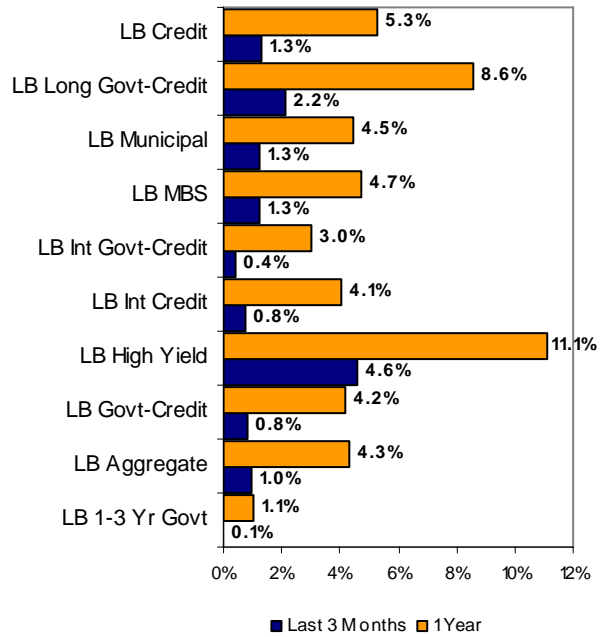
- Consumer prices remain calm, for now (a good thing).
- Producer prices are heating up somewhat, but not at an alarming rate (good).
- Housing prices are still roaring and inventories of unsold new housing product are high (not good, for a number of reasons; could be a true bubble).
- Consolidated federal deficits are growing almost out of control. For some reason, Iraqi oil sales have not only failed to fund the re-construction, but also those sales seem to be delivering little or no reductions in the US's massive nation-building cost in that rusted-out Iraqi economy (bad for essentially everything to do with US economic interests).
- Budget deficits of course create increased federal borrowing; if not reined in, the issuance of new Treasury debt will start to crowd the corporate bond market (bad for all borrowers, including government; causes all bond prices to rise).
- Outsourcing has caused labor contract negotiations to emphasize jobs preservation more than wage increases (good for inflation, not good for US productivity).
- The US Dollar has been weak and is still getting weaker (good for US exports, bad for inflation).
- The US trade balance/current account deficit is huge and still growing strongly, as US consumers and businesses largely ignore higher prices abroad, caused by the severely weakened dollar (bad for US inflation; especially bad for foreign-

based holders of US stocks, bonds and real estate).

- The worldwide price of crude oil is denominated in US Dollars; the dollar's declining value therefore translates quickly into oil price increases for the US and all economies that have dollar-pegged currencies. The price of oil has reached, and is holding at, near historic highs above \$50 per barrel, up from the low to mid-\$30s (bad for all US consumers; a killer for destitute airlines; the sheer size of the price increase and oil's pervasive impact on the economy will cause inflationary pressures).
- Commodities prices are rising steadily for the first time in a decade (not good; historically, a strong indicator of inflationary pressure).

One important constraint upon the Fed's stream of rate hikes is US bond market's reaction to it. When the Fed implements a higher rate on T-bills and the market fails to react by elevating its yields via bond price decreases, then the normal yield spread between the short and long term fixed income compresses. If this trend continues, the yield curve flattens, allowing investors to avoid the risk of holding long term debt while enjoying a similar yield via holding short term government paper. If the trend continues, the yield curve eventually inverts (T-bills yield higher than bonds), which is historically an almost sure indicator of impending recession. So, the bond market's continued failure to re-price bonds, if that happens, will act as an effective barrier for the Fed to continue its current round of rate boosts.

Fixed Income Returns

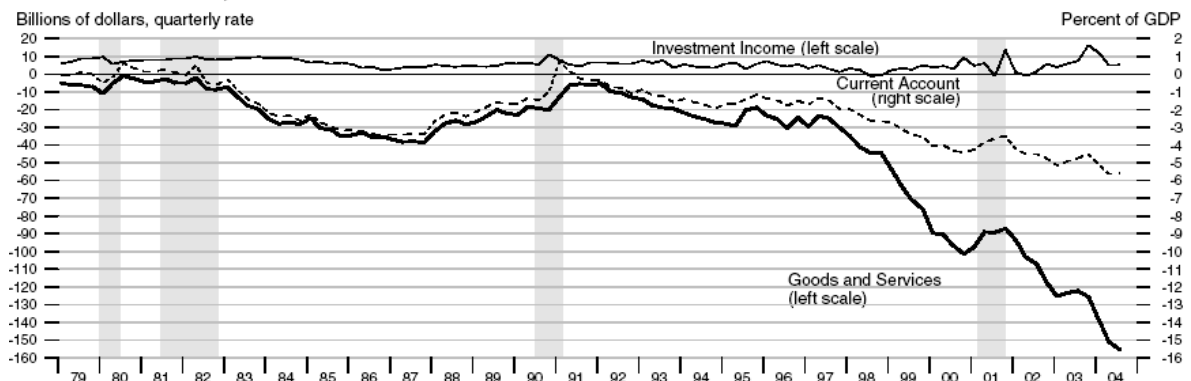


The US Economy

Bubble, bubble

The state of the US economy appears OK for now. But the seeds are sown for a highly leveraged future that will inevitably hinder growth, and particularly so when and as interest rates move upward. Corporate America's balance sheets are actually in good condition, but the same cannot be said for the other sectors. Consumers, unless they continue their borrowing binge, are all but spent, after having carried the nation's economy on their backs (especially autos and housing) throughout the recessionary business capital spending contraction from 2000 to 2003. In fact, personal consumption has now reached 70 percent of US GDP, an all-time record, while the personal savings rate has declined to all-time lows that are so near to zero the difference hardly matters.

Current Account, Trade and Investment Income Balances



The enormous (and growing daily) gap between the US's imports and its exports has for many years been financed by massive injections of foreign money washing ashore to buy up huge amounts of US government debt. Another way to finance a portion of the trade gap is devaluation of the US Dollar, but the declining dollar puts a real crimp in foreigners' US investment returns.

What's worse, the US now has a seriously growing internal budget deficit to go with its external trade one. The root causes of some government budget deficits can be productive, such as investment in infrastructure, which promotes commerce, and in technology, which improves the society's efficiency. But then, there are deficits caused by vast overseas spending that apparently produce little more than ideological benefits for the US. And finally, President Bush's proposal for revision of Social Security's financing would divert some of the System's current cash flows, so that about \$1 trillion of benefits (give or take a few billion bucks) that would otherwise be paid with those cash flows will have to be financed with new government debt, to be issued over the next 10 years or more.

So, evidence indicates that our private sector has grown addicted to borrowing, mostly for financing consumption. Meanwhile, the public sector seems to have fallen off its late-1990s debt-reduction wagon. As a generality, it is safe to conclude that government never actually "wastes" money, because at least two people will always provide support for each tax dollar spent: That dollar, after all, has been justified by at least one elected official and is also cherished by its recipient.

Where to from here?

In brief, debt that creates leverage can be rational and useful, but borrowing to buy more intoxicating spirits seems at best to be incendiary. Is there a pattern here? Can we now begin to expect a re-visit by the "Stagflation" economic horrors of the 1970s that resulted from 1960s "Guns and Butter" federal spending, without regard for revenues? (This time, there's a different political party driving the wagon, but will the result be different?)

Non-US Markets

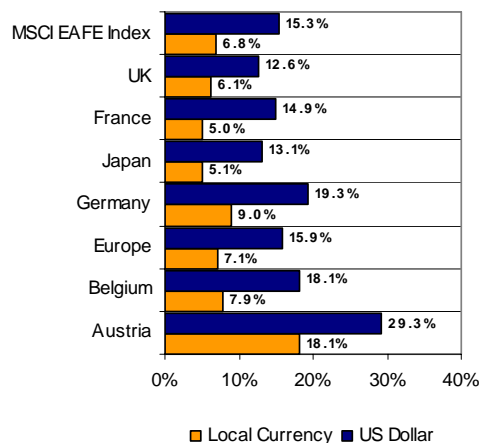
Expected returns are similar to US

When US investors first began dipping more than their toes into international markets during the 1980s, one of the compelling reasons for doing so was a demonstrated history of low correlation between US and foreign markets. This opportunity to diversify was attributable to a number of factors, but mostly it was antique accounting methods and lack of transparency among most non-US companies, even those that were traded in the US, via ADRs (American Depository Receipts). That era is gone. Strong accounting standards and high tech trading markets in developed countries are now as good as, or better than, the US.

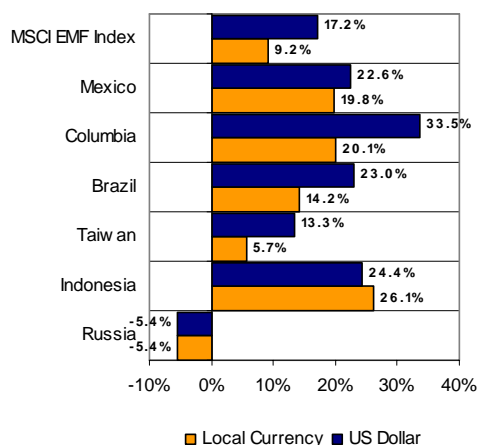
The primary reason for investing internationally now is no longer to improve portfolio diversification; it is simply to own shares of the world's best companies, regardless of which political jurisdiction they happen to call home. The major differential factor between markets that remains from

the past is currency. Currencies have always been an additional risk factor and, though most international bond portfolio managers hedge that risk back to the US Dollar, equity managers almost never do. So, the US Dollar's steep decline against all major currencies over the past several years has formed a significant performance tailwind for US investors in non-US equities (including ADRs, because they also have full currency risk exposure).

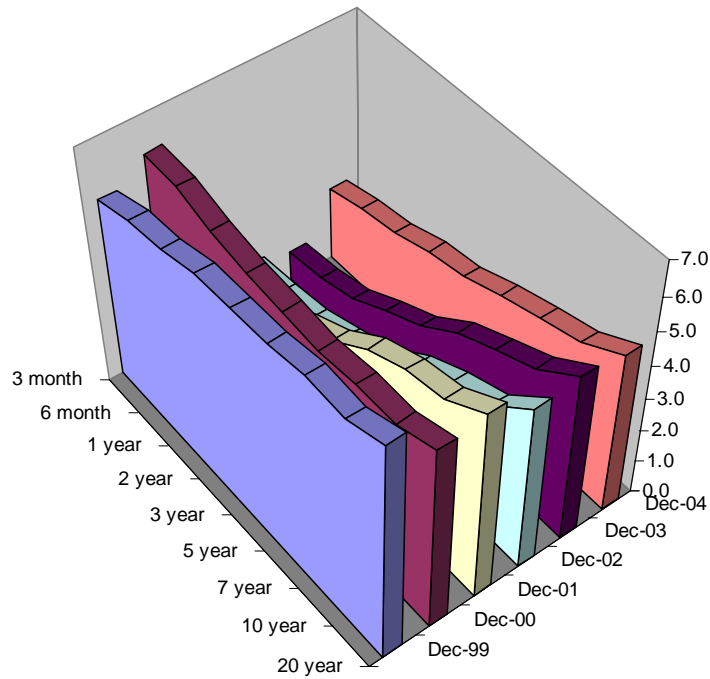
Developed Markets Returns 4Q 2004



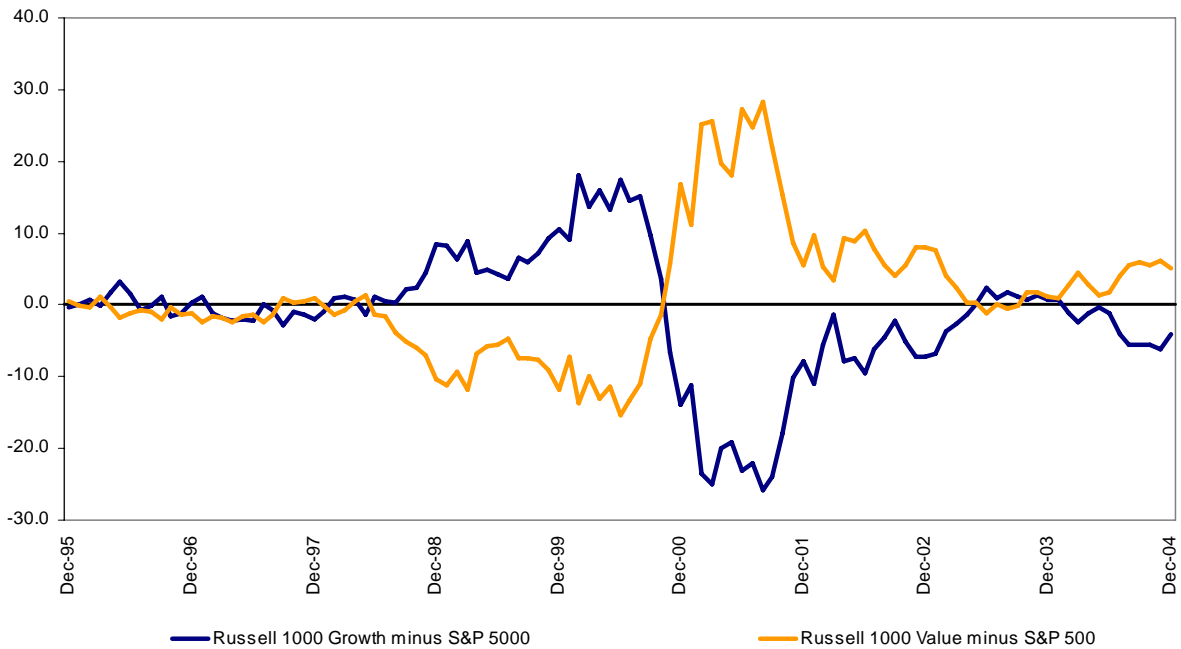
Emerging Markets Returns 4Q 2004



**U.S. Government Bond Yields
At Selected Quarter End Dates**



**Growth vs. Value Style Stocks' Performance
(rolling twelve months compound total returns) - Using the S&P 500 Index as a Baseline**



Historical Capital Markets Returns

as of December 31, 2004

	Quarter	6 Months	1 Year	3 Year	5 Year
Broad market measures/market sectors:					
S&P 500 Composite Index	9.2%	7.2%	10.9%	3.6%	-2.3%
Wilshire 5000 Index	10.3%	8.4%	12.6%	5.5%	-1.4%
NASDAQ Composite Index	14.7%	6.2%	8.6%	3.7%	-11.8%
Mid-sized & small stocks:					
S&P Midcap 400 Index	11.8%	9.2%	15.2%	9.3%	8.3%
Russell 2000 Index	14.1%	10.8%	18.3%	11.5%	6.6%
Investment style indices:					
Russell 1000 Growth Index	9.2%	3.5%	6.3%	-0.2%	-9.3%
Russell 1000 Value Index	10.4%	12.1%	16.5%	8.6%	5.3%
Russell 2000 Growth Index	15.1%	8.2%	14.3%	5.8%	-3.6%
Russell 2000 Value Index	13.2%	13.4%	22.3%	16.5%	17.2%
Specialty equity:					
Wilshire REIT Index	16.7%	26.4%	34.0%	23.6%	22.7%
Broad fixed income:					
Lehman Aggregate Bond Index	1.0%	4.2%	4.3%	6.2%	7.7%
Lehman Govt/Credit Bond Index	0.8%	4.4%	4.2%	6.6%	8.0%
Lehman Intermed Govt/Credit Index	0.4%	3.1%	3.0%	5.7%	7.2%
Fixed income sectors:					
Lehman Credit Bond Index	1.3%	5.5%	5.3%	7.8%	8.6%
International equities (in US Dollars):					
MSCI EAFE Index	15.3%	15.0%	20.3%	11.9%	-1.1%
MSCI Europe Index	18.6%	18.6%	19.5%	9.1%	-1.9%
MSCI Pacific Index	14.0%	10.0%	19.0%	14.3%	-3.7%
MSCI World Index	15.2%	15.4%	20.4%	12.2%	-0.8%

Returns for periods longer than 12 months are annualized.

FiduciaryVest, LLC**CONSULTING PHILOSOPHY**

We will carefully guard and maintain our personal and business integrity, recognizing that we can have no more valuable asset.

We will deliver quality information, advice and consultation needed by institutional clients, in order to reach informed, appropriate decisions regarding investment assets for which they are responsible.

We will design comprehensive investment programs and implement strategies that are both client-specific and appropriate to their circumstances.

We will neither directly, nor indirectly accept compensation arrangements with parties other than our clients.

We will maintain a significant, continuous commitment to investment research, development of useful tools and the evolution of strategies that are targeted to identified client contexts.

We will recruit talented individuals who share our passion for consultation with conscientious clients, and who have attained, or will seek to attain distinguishing expertise in their field.

We will continuously seek to enhance the investment education level of all clients, regardless of their sophistication.

FiduciaryVest, LLC**SERVICE APPROACH****Create or revise written investment policy**

- *Record client's governance context,*
- *Develop client's investment objectives,*
- *Identify client's investing time horizons,*
- *Define client's unacceptable outcomes,*
- *Determine client tolerance for exposure to unacceptable outcomes (risk),*
- *Arrive at appropriate asset allocation targets (unless participants control those decisions),*
- *Set suitable constraints and minimum expectation standards for portfolio managers, and*
- *Define general conditions for termination of portfolio managers.*

Devise appropriate implementation strategies

- *Identify and match investment styles with client's policy intent,*
- *Recommend suitable allocations to each style, and*
- *Perform searches for appropriate portfolio management.*

Deliver ongoing strategic advice

- *Perform quarterly investment performance evaluations and analysis, compared to objectives, policy, appropriate benchmarks and sound investment and business principles,*
- *Make recommendations for adjustments and enhancements to policy and portfolio management, and*
- *Perform relevant special studies.*

Statements made and facts presented herein are believed to be from, or based upon reliable information sources; however, FiduciaryVest, LLC does not offer any assurance about the accuracy of data in this publication, or the validity of the conclusions and opinions derived therefrom.

This publication is not intended for, and should not be used as a source for actionable investment decisions.

FiduciaryVest, LLC is an independent, fee-only, registered investment adviser, pursuant to the Investment Advisers Act of 1940. It provides advice to institutional clients, based upon each client's specific investing circumstances and objectives.

FiduciaryVest, LLC*Investment Strategies for Fiduciaries*

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