

## Here's Something Different!

Welcome to our premier issue of "On the Horizon". We've changed to a newsletter format for our quarterly client communications based on suggestions from clients and advisors. The idea is to convey the same sorts of commentary and information in a more user-friendly format. We certainly hope you enjoy our new layout as well as the commentary. If you have any thoughts or ideas that you would like to see discussed in future issues, please let us know.

## The Science and Art of Portfolio Design

Joe and I recently returned from a trip to Denver for the annual meeting of the Financial Planning Association. One of the speakers was Daniel Kahneman, a Professor of Psychology from Princeton, who received the 2002 Nobel Prize in economic science for his work in the field of Behavioral Finance. Normally, economic theory is based on the assumption that investors are both rational and unaffected by emotions. Dr. Kahneman and his colleagues have spent years studying investor behavior in the real world and have demonstrated that investor behavior and the behavior of markets is *anything but* rational and unemotional.

We need look no further than the 1999-2000 stock market bubble and the "irrational exuberance" of that period to see that their research has some basis. This irrational behavior even applies to professionals. For

example, well-known investor Warren Buffet of Berkshire Hathaway "second guesses" himself in the following excerpt from his 2003 annual report:

*"We are neither enthusiastic nor negative about the portfolio we hold. We own pieces of excellent businesses – all of which had good gains in intrinsic value last year – but their current prices reflect their excellence. The unpleasant corollary to this conclusion is that I made a big mistake in not selling several of our larger holdings during The Great Bubble. If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I."*

As portfolio designers here at Horizon, we continue to stay abreast of developing research and its application to the construction of our clients' investment portfolios. We follow well-defined systems and procedures which help us to maintain our policy discipline and to avoid making these sorts of irrational and emotional decisions in response to short-term market performance. This helps us to blend the science and mathematical constructs of design with the emerging information about investor behavior to make sure that our clients and their portfolios will stand the inevitable tests which time will provide.

### COLLECTED THOUGHTS

*"Money is not everything, but it helps make the important things possible."*

- Ben Stein

### Manager Spotlight—Muhlenkamp

Last May, I attended the Financial Planning Association's Annual Retreat, which was held in Colorado Springs. This event provided opportunities to listen to panelists and portfolio managers and to exchange ideas with many of the national leaders in the financial planning profession. While I was there, I had a chance to visit informally with Ron Muhlenkamp. His Muhlenkamp Fund is included as a mid capitalization value investment in many of our clients' portfolios. He's been in the investment management business for his whole career, beginning in 1970. Ron is a bright guy, with an engineering degree from MIT and an MBA from Harvard. He formed his company in 1977 and has been the portfolio manager for the Muhlenkamp Fund since its inception in 1988.

Ron spent the early years of his career studying the economy and financial markets and based on his study, he's developed an unusual and effective valuation methodology for selecting individual companies for investment. Ron is a long-term value oriented investor who believes that inflation and interest rates drive market valuations. As to our current markets, he believes that inflation and interest rates will remain relatively low. His expectations are that investment returns will be lower, but still positive, and that equities will substantially outperform cash and bonds. He's done a terrific job over a long period of time and we continue to appreciate his thoughtful analysis and recommend the Muhlenkamp Fund for many of our client portfolios.

### Market Review

The following table shows market index returns for the 3<sup>rd</sup> quarter, year to date and past 12 months.

Index	3rd Qtr	Year to Date	One Year
S&P 500 (Large Stocks)	-1.86%	1.51%	13.87%
Russell 2000 (Small Stocks)	-2.84%	3.72%	18.77%
EAFE (International Stocks)	-0.23%	4.62%	22.55%
Lehman Bond Aggregate	3.20%	3.35%	3.68%

Domestic and international equity markets were slightly down for the quarter. The economic outlook continues to be mixed, with ongoing geopolitical uncertainty, concern about economic growth and earnings, as well as the upcoming presidential election weighing on investors' minds.

Inflation remains at low levels, but there are certainly inflationary concerns about rising oil prices, which have recently reached \$50 per barrel. This increase is due to supply weakness and the continued growth in demand in many developing economies, and is magnified by continuing geopolitical uncertainty, particularly in the Middle East.

On the other hand, longer term market interest rates remained low, indicating that bond market participants are not anxious about any significant rise in inflationary pressure. Recent volatility in rates continued as longer term rates rose dramatically during the quarter, returning to their levels of last year. Short term rates continued their upward move, as the Fed increased its target rate to 1.75% with two 0.25% increases, one in August and one in

### Market Review continued...

September. This increase in short term rates bodes well for our clients' cash flow as shorter maturity bonds and money market fund rates, which are sensitive to these short rates, earn higher interest payments.

Our expectations continue to be for moderate equity returns, possibly in the 6-10% range and we expect flat to moderate increases in inflation and interest rates for the near future.

### Keeping Our Focus Where it Belongs

For the past few quarters, we've provided index returns and investment commentary in our newsletters and we will continue to do so. But, it's important to keep our focus on the long term. Paying too much attention to seemingly urgent "current events" and predictions can lead to distraction. It's certainly interesting to be aware of the short term comings and goings in the markets; but, current events are largely "noise" in the longer term. Investors are, as Dr. Kahneman suggests, subject to making irrational or emotional decisions based on these current events and we should be careful about reacting (or at least about overreacting) to them.

The real determinants of long term investment performance are the long term returns which come from being consistently invested in the appropriate places with your portfolios managed by the right people. Over the long haul, the markets will work their magic.

I read a remark by Jane Bryant Quinn, who said, *"The secret to wealth is that a secret doesn't exist. For success, you need only a simple investment, with profits compounded over time."* Some might argue with her use of the word, "simple", but her point is the same as I've heard expressed in another way – "it's time in the market versus timing the market" which makes all the difference to investing success.

It's our job to keep our clients and their portfolios focused on the achievement of their long term goals and objectives and to keep them (and us) from being distracted from current events which might lead them to make decisions out of context. With this in mind, we will continue to design and monitor our clients' portfolios to be adequately diversified and take advantage of what the market provides.

Thank you very much for your continued confidence in our service and advice. If you have any questions or comments or would like to schedule some time to come by and review your goals and objectives, or to just visit, please call.



## Making Cents

### Investment and Portfolio Matters:

While we do not recommend that you allow the "tax tail to wag the investment dog", we do suggest a regular review of your portfolio to make sure that you are being tax-wise.

- Review your holdings and consider selling securities which are in loss positions. You can use these losses to offset capital gains, either in your investments portfolio or from other activities.
- Do you own Microsoft in your portfolio? If so, you are probably aware of the large one-time dividend which they intend to pay to shareholders later this year. Depending on what you paid for your shares (and especially if you have an unrealized loss), you may be better off, tax wise, to sell your holdings before the dividend is paid. If you would like to see our more comprehensive thoughts and analysis, please visit our website at [www.horizon-advisors.com](http://www.horizon-advisors.com) or call if you have questions. We will take appropriate action in our client portfolios.

### Income Tax:

- Prepare an estimate of your 2004 tax liability before the end of the year. Doing this in advance will both make you aware of any issues which might impact you as well as give you time to plan or take action to avoid unnecessary taxes. Many of our clients are subject to the Alternative Minimum Tax ("AMT") and this sort of tax review may identify planning measures which can be taken to reduce or eliminate this tax.

### Estate and Gift Taxes:

- The estate tax credit remains at \$1,500,000 per person for 2004 and 2005. It will rise to \$2,000,000 in 2006.
- The annual gift tax exclusion, or tax free gift amount, is \$11,000 per person for each donor. So, a husband and wife can each make gifts of \$11,000 for a combined total of \$22,000 to each child or grandchild. If you have not made your annual gifts, they should be made before the end of the year.

### Finally and Most Importantly:

With the holiday season approaching, don't forget to COUNT YOUR BLESSINGS!

#### COLLECTED THOUGHTS

*"What a wonderful life I've had. I only wish I'd realized it sooner."*

*- Sidone Gabrielle Colette*



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