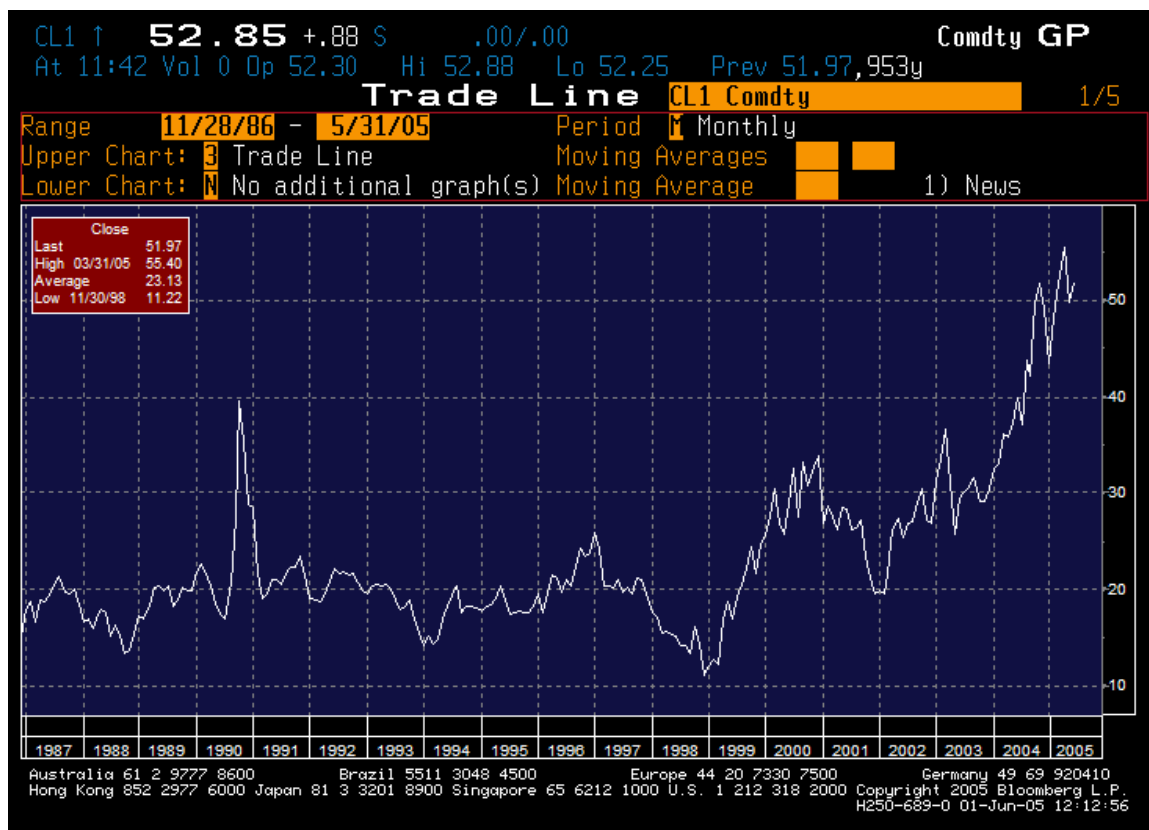


Investing in the Second Half of 2005...Expect Better Returns.

The first four months of the year were rough by any standard. The S&P 500 was down 4%. NASDAQ delivered a negative return of 11.67%. The Russell 2000, a measure of smaller capitalization issues, was down 10.76%. The profound worries were the rising price of oil, concerns about a housing bubble, and fears that inflation would re-emerge. However, May appears to be a transition month, and we see clearer skies ahead.

Higher oil prices impact us all. They add to our cost of living in many ways. Fed Chairman Alan Greenspan estimated that the higher cost of imported oil to be in the neighborhood of \$80 billion. That figure represents about .75% of our nation’s GDP. The added cost drags our economy and remains a wildcard for investors. If prices sustain themselves at \$65 or more per barrel, the markets will feel discomfort. We don’t see this happening, but if it did, it would change our increasingly positive outlook. A long term chart detailing the price of oil places the current levels in perspective.

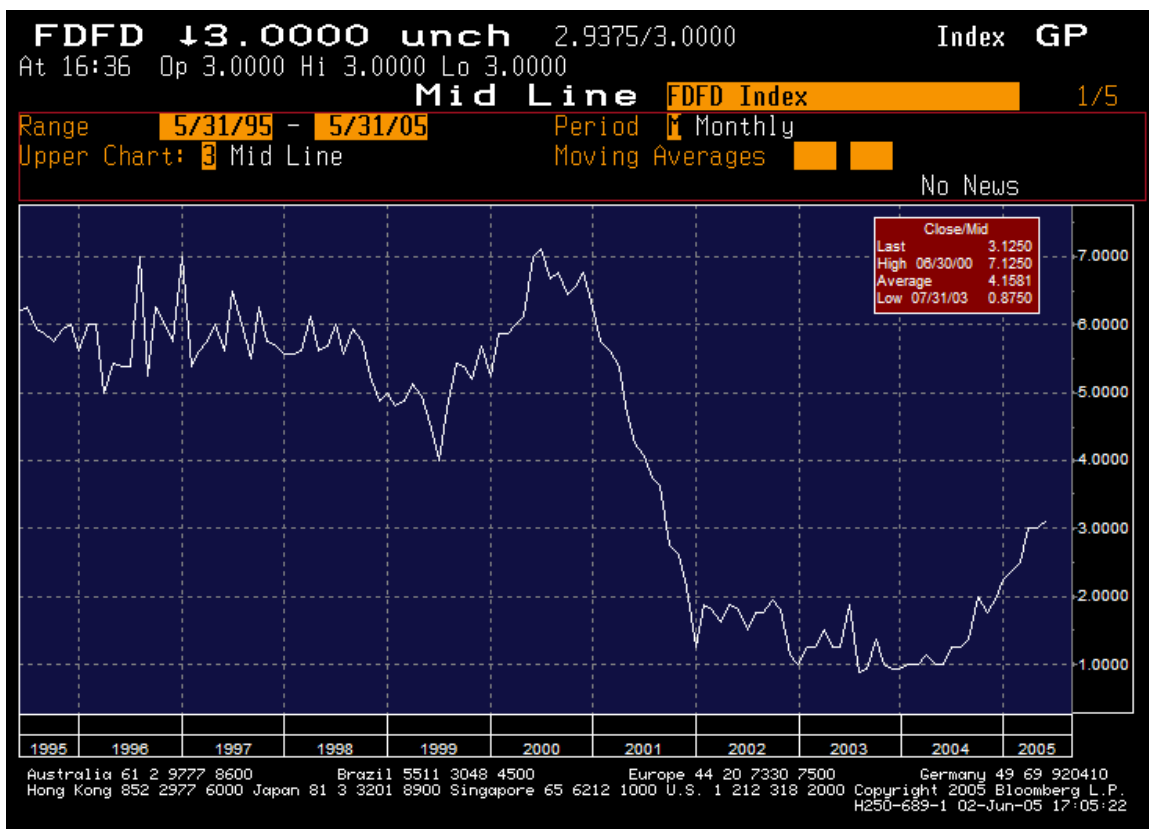


Source: Bloomberg

Brian Westbury of Claymore Advisors wrote an outstanding editorial for the May 31, 2005 edition of *The Wall Street Journal* (attached). The main theme was that fears of a U.S. housing bubble are overblown. We are more concerned with the structure of certain types of mortgage loans than we are with housing prices generally. There are specific markets that have a speculative feel to them, but low cost “interest only” loans that convert to conventional mortgages in three to five years may cause more of a shock

than is currently anticipated. You can read the article and come to your own conclusions, but Brian’s essay makes some excellent points that have implications that go well beyond the housing bubble debate.

- The Fed’s actions, until late, have created a real federal funds rate (fed funds minus inflation) below 0% for more than two years. The Fed has created an environment where bubbles can exist. (We are more concerned about the leverage in the financial system being used to execute “carry trades” than we are about housing prices.)
- History has shown that the Fed makes its worst mistakes when it takes its eye off inflation. (Mr. Greenspan understands this. The risk is that the Fed overshoots and dampens the economy too much.)



Source: Bloomberg

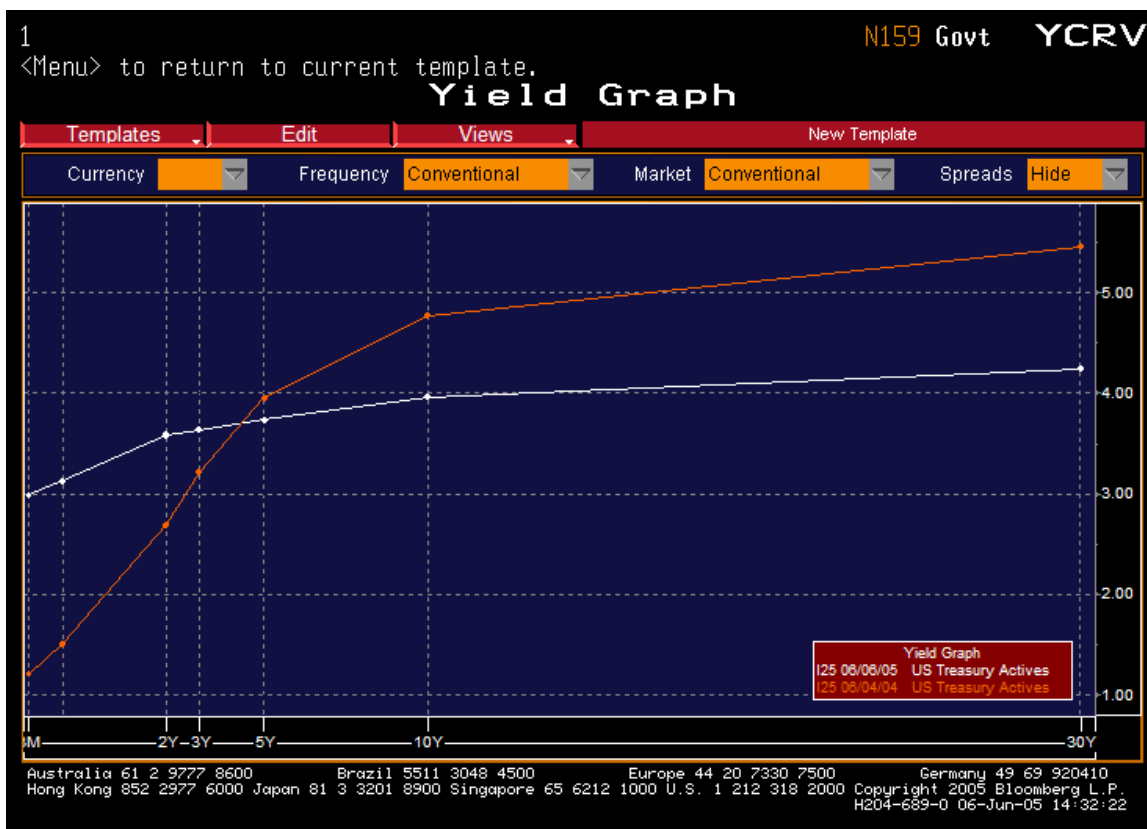
The domestic economy does not appear to be overheating. The combination of higher crude oil and gasoline prices, rising interest rates, and a lack of fiscal stimuli has started to put the brakes on inflationary pressures. We expect the Fed to raise short rates by another 25 to 50 basis points before year-end. It may not be necessary, but it should put inflation fears to rest. Markets move and money is made when perception changes. The recent move in 10 year treasury yields to below 4% indicates that perception is changing. Rates have reached such low levels because the world is awash with dollar liquidity: witness the unprecedented levels of holdings of US Treasury bonds as well as US equities by our leading world trading partners. Corporate America is in terrific

financial shape with clean, solid balance sheets which are flush with cash. Consequently, equities should perform better in the latter part of the year.

Fixed Income

The shape of the yield curve presents another problem. Should an investor own fixed income at these levels? Let us frame our comments by acknowledging that we treat each client individually. For some, an “anchor” portfolio of intermediate duration (4-5 years) bonds should be established. It should be actively managed for after-tax returns, taking the alternative minimum tax into consideration. Apart from acting as a portfolio anchor, we remain wary of bonds.

Our principal concerns center around two issues. First, the yield curve remains flat. Investors are not being compensated for owning longer duration securities. It is difficult to make a total return argument for fixed income at these levels. Even if the 10 year treasury trades to a 3.5% yield, the total return on investment is less than compelling.



Source: Bloomberg

Second, in January, we wrote about our concerns with credit spreads. The scramble to find yield is causing investors to take on credit risk they would prefer to avoid. The explosion of spreads in the auto and auto parts sector is a mere preview of what could happen. The following chart detailing the credit spreads of General Motors bonds over

the past 6 months illustrates our concern. The GM 7.7% of 4/15/16 went from a spread of 230 basis points over treasuries 6 months ago to over 600 basis points today. Please see the following chart. As we predicted, spreads have started to widen and we believe they will continue to do so. High yield bonds and emerging market debt are still vulnerable.

Yield Spread of GM 7.7% due 4/15/16 vs. Treasury 4 1/8 5/15/15



Source: Bloomberg

A Word About Hedge Funds

The press is having a field day reporting on hedge funds. Many of you have heard our views, but here they are again in summary:

- The best investment athletes are leaving large traditional asset management firms and moving to smaller, more nimble firms. Most of these talented people are working for hedge funds. Some can be found in boutique “long only” organizations.
- Many (25% or more) hedge fund managers will fail. Failure comes in many forms including poor investment performance, lack of success in short selling, improper use of leverage, the inability to build and manage infrastructure and the mismatch between asset size and investment opportunity.
- A larger percentage of hedge fund managers (50%) will produce positive returns that are not competitive on a risk adjusted basis.
- A small percentage of managers will produce outstanding returns over multiple market cycles. Common traits among these managers include limiting the size of their fund, staying with a specific narrow discipline and executing well, building and retaining a talented group of people, expending equal energy in the research phase to the taking of short as well as long, positions, and having a meaningful amount of their own money side by side with investors.
- We have an aversion to leverage. As a result, we have a bias toward long/short equity managers who do not employ meaningful amounts of leverage to achieve returns.

July 1, 2005

- "Hedge Funds" are not an asset class. Instead, they represent a philosophical break with traditional money management methodology. Just as in traditional equity and fixed income areas, there are good managers, mediocre managers, and poor managers. A thorough and thoughtful due diligence process will distinguish one from the other. We judge and compare each manager on his/her merits.
- We continue to focus on passionate stock pickers that are benchmark insensitive. Some of these people are talented short sellers and incorporate this into their portfolio management process; others operate in the traditional "long only" arena.

We welcome the opportunity to discuss our views with you. Please call or email us if you would like to dig deeper into any of the above.

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