The year 2004 ended with a flourish in the equity markets while a number of the themes we have been tracking in past quarterly letters seemed to have dropped off the radar of the financial media or reversed course.

The S&P 500 Index closed the year with a gain of 10.88%. Valued oriented stocks outperformed growth oriented stocks as represented by the S&P/Barra Value and Growth Indices which rose 15.71% and 6.13% respectively. Small companies lead the markets with the S&P Small Cap Index returning 22.65% for the year. The Energy, Utilities and Telecommunications Services Industries were the biggest contributors to the gains of the S&P500 Index, posting gains of 28.77%, 19.60% and 15.98% respectively.

For the fourth quarter there were some interesting changes in the movements of the markets. A majority of the year's gains were found during the fourth quarter as 9.23% of the S&P 500's 10.88% occurred during the quarter. In addition, the quarterly returns of the S&P/ Barra Value Index just barely topped those of the S&P500/ Barra Growth Index, 9.93% to 8.51%.

Likely one of the late drivers for equity prices in this last quarter was the retreat in energy prices, especially crude oil prices which fell from all time highs in the third quarter to more normal levels at the end of the year. At the beginning of the fourth quarter the price of crude oil was north of $60 a barrel, but closed the year in the low $40 range. In addition, the uncertainty bound up with the U.S. Presidential election has been put behind us as corporate America learned who would occupy the White House for the next four years.

On the economic front, we saw many of the same trends continue. The Federal Reserve Open Market Committee raised interest rates twice during the quarter for a total of another 0.50% to a 3.25% target Fed Funds rate. The unemployment rate remained relatively steady and ended November at 5.4% while preliminary data shows modest gains in total non-farm jobs. And GDP continued to rise with final data for the third quarter showing growth of 4%.

The continually weakening dollar has been another emerging theme. The U.S. dollar has repeatedly hit new lows against the Euro and other currencies in the last quarter, making U.S. manufactured goods less expensive and thus more attractive to consumers overseas. We invest in many companies that derive a large portion of their revenues from overseas sources and expect that those companies will perform well as their products and services become more competitive in a global marketplace.

We are encouraged by number of further indicators which suggest to us that 2005 will be another good year for equities. A number of these are outlined in an article "7 Key Indicators for the Next Bull Market" by Donald H. Rowe, published by Zachs.com, where he argues that:

- Despite the fact that the Federal Reserve has been steady in increasing interest rates lately, rates remain at historic lows, giving businesses and consumers the ability to borrow money very cheaply.
- The tax cuts initiated by President Bush seem to be working. Tax cuts create faster economic growth, which in turn creates more jobs.
- Economic growth is also boosted by government spending. The current Congress has been continually increasing spending, pushing deficits to record highs.
- With rates so low, gains on cash and other short term securities are minimal while equity returns and earnings growth far surpass those, suggesting that the record amounts of cash currently on the sidelines will likely move toward the stock markets.
- The dividend discount model of market valuation (a widely followed model) suggests that the S&P 500 may be significantly undervalued. All these seem to indicate that the stage is being set for further advances in the equity markets.
- The “Smart Money Index,” a technical indicator, is forecasting dramatically higher stock prices ahead.
- And, the recent passage of the Homeland Investment Act which allows American corporations to bring offshore profits back into the country at a drastically reduced tax rate (5.25% instead of 35%) will encourage the repatriation of more than $670 billion which will need to be invested in capital, repurchase shares, pay extra dividends, acquire other companies or pay down debt.

We are optimistic and hopeful for the year ahead and we look forward to financial markets where stock prices will accurately reflect corporate performance rather than historical economic malaise, geo-political events, or non-financial events. As always, we continue to analyze the new data that comes in and work to refine our models and investment process. If you have questions or concerns, please don’t hesitate to contact us. We wish you a happy, healthy and prosperous 2005.