AMARILLO OFFICE

320 South Polk, Suite 301
Amarillo, Texas 79101
806-371-9233

3rd Quarter 2004

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

"A whole lotta nothin' – Part 2"

July through September was very similar to the 2nd quarter in several ways. First, the markets ended up at the end of the quarter at almost the same level they started the quarter. Second, the focus of the markets was on the Fed, energy prices and geo-political forces. Third, profit growth at companies was pretty good. As a result of decent profit growth and flat stock prices, valuations for stock prices continued to improve.

The summer doldrums were very apparent through most of the quarter as the majority of Wall Street seemed to be enjoying their summer in some nice locale, away from their trading posts. Volume was extraordinarily light, volatility was as low as we have seen it in 10+ years, and stocks traded in a relatively small range. Small rallies were met by pullbacks, a few rather sharp, and stocks just simply could not make any progress one way or the other.

The Federal Reserve raised the Fed funds rate twice during the quarter and long-term interest rates, set by the market forces of supply and demand, actually declined. This is counter intuitive to some people but the reality is that the economy is not showing signs of significant growth. (More on that in a moment.) As a result of this, interest rates did not have a meaningful impact on stock prices.

"Where's the beef, err growth?"

Probably the most interesting development that is occurring right now is the inability of the economy to show meaningful signs of growth. It makes us think about the popular commercial asking, "Where's the beef?" This is a common question that we are asked and it is a very valid question. The economy seems to be unable to pick up significant momentum. Growth is there, no doubt about it, but it is not as robust as one might hope for at this stage in the economic cycle. One reminder before we get into this, we are not economists and we do not invest based on 3% GDP vs. 4% GDP, but we have to focus on the overall growth in the economy and how that is going to affect the cash flow growth of the companies that we own.

Why is the economy not growing more? This is the political season and you can hear 101 reasons why politicians think it is not growing as fast as it should be and inevitably there is finger pointing and blame passed around. What surprises us is how little people seem to focus on market forces that have NOTHING to do with politics. Naturally, that does not help one get elected, so it makes sense that they seem to focus on passing blame or taking credit, depending on their position, but it still has nothing to do with reality. Can politicians and the government have an impact on the economy? Of course, but the government can really just put policies and programs in place that should contribute to economic growth. From there, market forces determine the actual speed and duration of economic expansion and contraction.

Let's look at what we have seen in the last three years as the recession has ended and expansion has started. Congress has passed massive fiscal stimulus and the Federal Reserve has dramatically lowered interest rates to provide monetary stimulus. Are these methods working? Absolutely! It scares a person to think of how long the recession might have lasted and how deep it might have become if those steps were not taken. Why then is the economy not growing as fast as one might hope? A point of clarification is in order. This expansion has certainly seen less dramatic growth than some of the expansions in history, but the expansion has still been material. GDP growth has consistently been in the 2 to 3% range for 2003 and 2004. This is not shabby growth and when coupled with what appears to be moderate levels of inflation, is not dramatically below trend.

Why then do we hear that growth is "anemic"? Most people are thinking of employment growth when they make comments like that. Or they might be talking about sales growth at companies, but the actual government figures showing overall expansion of the economy have not been "anemic" when compared to history. Slower yes – anemic no.

What has the economy been dealing with? Energy prices have more than doubled. Can a politician or a government control energy prices? No, at least not over a short period of time. When demand outstrips supply, which has been artificially suppressed for long periods of time (that is a whole other story), prices go up. This is a direct tax on the economy. There can be no question that the dollars spent on increased prices and the psychological impact of higher prices have had a slowing effect on the economy. We have seen estimates that the impact of energy prices has removed at least one to two full percentage points off GDP growth.

The war on terror has been a real issue for the American economy. Granted it has not had a direct impact on spending patterns, other than government spending, but it has had an impact on the psychology of the consumer and business leaders. This is going to affect spending habits and capital allocation decisions. Government and politicians did not decide to create this uncertainty – 9/11 did – and there is nothing a government can do to change it other than try to make people feel as safe as possible. One cannot possibly quantify what this impact has been, but no one will argue that it has been material to the growth of the economy.

The U.S. consumer continues to be up to their eyeballs in debt. While there has not been a disaster, as some have predicted where the consumer becomes virtually bankrupt, the "stretched" consumer is not going to increase their spending as dramatically as they may have done in the past. The increased leverage taken on to maintain consumption levels of the consumer helped keep the recession from being deeper than it was. As a result, the spike in spending that typically occurs has also been more measured. The consumer does not have as many new discretionary dollars. Was it the government's decision to have most people refinance their mortgage, spend the savings and then ramp back up their revolving debt levels? Of course not. It is also not within the government's power to force families to be more disciplined. It is simple – if families have less money, through savings or borrowing to spend, they will spend less. The consumer is not in a position to ramp up spending levels the way they have in expansions of the past. This is a reality, and it is not going to go away anytime soon.

<u>What to do?</u>

Okay, where does that leave us today and what are we doing about it with regard to our investments? This kind of environment makes it very difficult for companies to find new avenues for growth. When you get right down to it, there are five ways for companies to increase revenues:

1) Overall economic growth.
2) Be in a sector of the economy that is growing faster than the economy.
3) Take away market share from competitors.
4) Raise prices.
5) Acquire other companies.

Certainly, there are other subtle ways companies can increase revenues, but this covers the vast majority of sources of increased revenue.

When you look at the economic environment in the U.S. today, there are several basic realities that we have to accept. As discussed earlier, the overall economy is not growing very fast. In fact, some sectors of the economy are contracting. Another fact to consider is that a large percentage of the earnings gains of the last year and a half have been as a result of cost savings measures. Eventually cost savings are maximized and companies have to grow revenues to grow earnings. In a modest economy this is a big challenge. Additionally, there have been massive increases in productivity in the economy over the last 15-25 years. This means that job growth is inevitably going to be challenged by the fact that machines can often do more work than human employees, and do so faster and cheaper. All of this creates an environment that makes it difficult for companies to sell more widgets than they did last year.

For this reason, we stay focused on companies that are managing their businesses well and growing their revenues. In some cases, like Genentech, this comes from new products. In others, like General Dynamics, it comes from a growing economic sector and strategic acquisitions. In many cases we have found growth in companies, like United Healthcare, from a growing sector and growing market share.

One of the reasons this has been a challenging period for the broad market averages is that the broad averages are just that – broad. Therefore, the companies that make up those averages cover a large range of situations. Many of the companies in the average are growing faster than the economy, but many of them are not. This certainly has a dampening effect on the overall growth of the market.

This is yet another reason we focus on the individual company first. It is extraordinarily difficult to predict what the overall economy is going to do. In the investment world we feel it is best to focus on what is more predictable. We want to invest using variables that we have a high degree of confidence that we can forecast. To us, we believe we have this ability in forecasting company cash flows. An example of this is we are confident that United Healthcare is capable of growing its revenues and earnings from a combination of the tools listed above. In their case, maybe one-third of the growth is from the economy itself, another one-third from market share gains, and another one-third from acquisitions. We focus on the growth that this company can realistically be expected to generate in revenues and then, more importantly, what this growth will translate to in cash flow.

This is why we are stock pickers and why we will not deviate our focus from stock picking. If we can accurately predict the growth of cash flow, we are confident that we can predict stock price appreciation with realistic accuracy.

As always, for those clients with taxable accounts, we will begin the process of optimizing the tax structure of your accounts. As a result, we may take steps to harvest tax losses, reestablish positions and reduce our basis, or defer transactions until January. This certainly could cause an increase in the turnover of the portfolio in the last two months of the year. It is very important that you let us know if there are any special circumstances that we should be aware of that would impact our decisions. Never forget, we will not let the "tax tail wag the dog," but we will do what we can to make your investments as tax efficient as you desire.

Please let us know if you have any questions. We hope that everyone has a wonderful Holiday season as we close out the last two months of 2004.

All my best,

Christopher Alan Zook
Chairman and Chief Investment Officer