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4th Quarter 2004

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

Finally Something Happened!

Well, after watching paint dry for the 2nd and 3rd Quarters, the markets finally woke up. The uncertainty caused by the geo-political factors, primarily the Presidential election, created an incredibly stagnant market environment for most of 2004. Fortunately, once some of the uncertainty was removed, the markets responded by posting a strong rally in the 4th Quarter. There is no question that one of the greatest enemies of the stock market is "not knowing." In this case, what mattered to the market was that we elected a President, without a debacle like 2000. Not only did the people elect a President, but he was elected with both a popular vote majority and an Electoral College victory. While some market participants preferred one candidate over another, what they really all wanted was a clear winner.

The response to this was a very sharp rally in all of the major stock indices. For the quarter, the S&P 500 index rallied by more than 9% and the Russell 1000 Growth index gained almost 9%. This resulted in a gain for 2004 of approximately 10.8% for the S&P and just over 5% from the Russell 1000 Growth. We are very pleased to report that all of our portfolios had very good absolute and relative performance for the year. The Cornerstone Portfolio increased by approximately 11% and the Concentrated Cornerstone Portfolio grew by more than 17%. Our strong performance was a result of good stock selection. We are pleased with the way that our companies performed for the year and that strong operating performance was reflected in their stock price.

One of the things that surprised people was how little volatility there was in 2004. Certainly some stocks may have moved around a bit, but the overall market experienced VERY low volatility by historical standards. The 2004 stock market was one of the least volatile in the last 40 years. The good news about this is that there was not the kind of wild gyrations that we have grown to expect. Therefore the market was fairly reflective of the performance of the underlying business that it represents. It is well known that last December we thought that our companies would grow cash flow by approximately 15% in 2004 and that there was 5-7% risk to valuations. As a result, we felt that the market could potentially return between 8 and 10%. As it turned out, those numbers were fairly close to reality. The results of the market were very solid for the year and were extremely favorable when compared to the rate of inflation or other possible investment vehicles such as bonds and money market investments.

All of this is history, though. What about the future? What can we expect from 2005? There are a number of very important factors which affect stock prices. We will touch on only a few that we believe will be the key drivers for the year. We will always stay focused on company specific fundamentals as our primary decision-making tool, but we will discuss some of the factors which we consider with regard to our assumptions on valuations.

1. **Corporate Profits** – Companies will continue to grow their profits in 2005. However, they will do so at a slower rate of growth than they did last year. As discussed last quarter, the key for companies today is identify ways to increase revenue. This continues to be a challenge. The good news is that companies, as a composite, have used their large amounts of cash flow to improve their balance sheets and to increase their dividends. As you can see from Figure 1 below, the net debt to capitalization of the S&P 500, ex- Financials, is at the lowest level it has been in more than 15 years. It has declined from 47% to less than 33%. With these improved balance sheets, most companies are now in a position of financial flexibility that should serve them very well in the future.

Figure 1 – S&P 500 ex- Financials Net Debt to Capital

Source: FactSet and Smith Barney U.S. Equity Strategy

2. **Inflation** – While inflation is increasing, it is not accelerating at a rate that causes us tremendous concern. Most of the inflation we see is coming from increased energy and raw material costs caused by growth in worldwide demand. This demand spiked and is now settling down to a more normalized level. We do not see inflation being a major problem in 2005.

3. **The U.S. Dollar** – Following the serious decline in the second half of 2004, the dollar appears to be stabilizing. We anticipate the dollar will remain in a broad trading range at more or less the same level as it is today.

4. **Interest rates** – This is probably the second most important variable we consider with regard to valuations, behind profits. We expect that the Federal Reserve will continue to increase the Fed Funds rate to a more normal 3% rate, from the 2.25% level it is today. We also believe the increased level of economic expansion, pressures from inflation, a weakened U.S. dollar, the deficit, etc. will cause the 10 year Treasury Bond to move from its current level of 4.19% to approximately 5%. This is probably the variable that we have the least amount of confidence in. We can actually build a pretty good case that the 10 year may actually stay pretty much the same, if the economy stays on its current course.

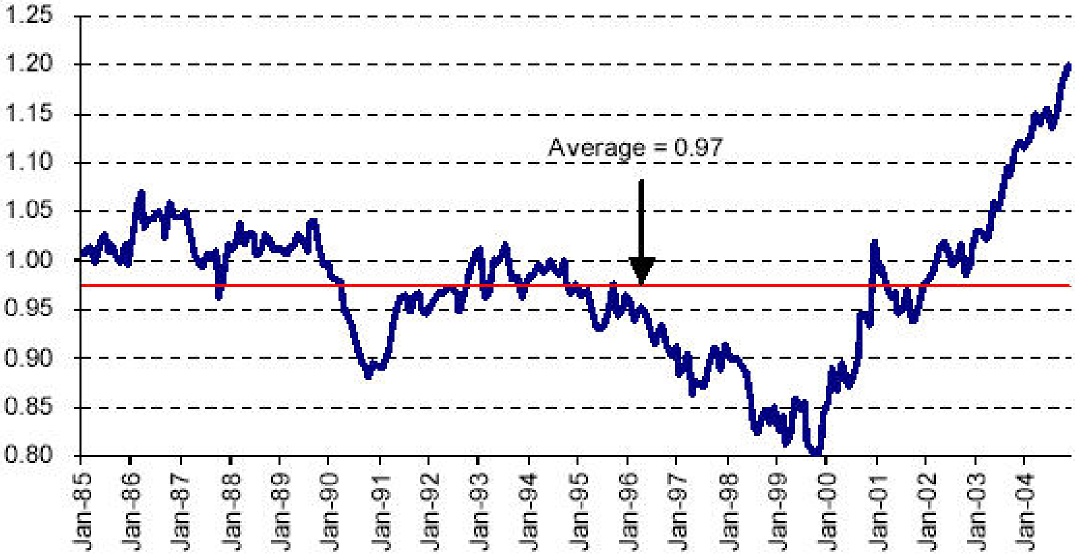
5. **Current Stock Market Valuations** – While this may make us sound like a broken record, we feel valuations are reasonable today. After the strong rally of the 4th Quarter, valuation metrics are certainly not as favorable as they were in July, but they don't cause us tremendous concern. Since 1940 when P/E multiples begin the year in the 18-20 range, the average return in that next year is 7%. Naturally, 7% is not a number to get extremely excited about. However, it is still greater than current yields on bonds and cash. Valuations are always very difficult to predict, but we feel that they will contract by approximately 5-7% this year.

That is a natural lead-in to what we expect for 2005. As most people know, we do not like giving predictions as to what the broad market will do. Reporters always ask, though, so we must therefore be prepared to give an answer. We always provide our answer based on what we expect from our portfolio companies. Based on what you read above, we expect reasonable profit growth with a slight decline in valuations. All of that adds up to moderate, but positive, expectations. We believe our companies will grow cash flow by approximately 12% this year, and that valuations may decline by 5-7%. This would give us a return expectation in our portfolio of 5-7% plus dividends. The greatest variable we see in that forecast is valuation risk. We have a high level of confidence that our companies will achieve the 12% cash flow growth, but we can build a strong case that valuations may decline by as much as 10% **or** actually increase, based on privatization of Social Security, etc. Naturally, we hope that the markets will yield greater returns and that companies will grow cash flows by larger amounts, but based on what we know today, we are comfortable with these numbers.

Two interesting observations we will point out. Dividend yields and valuations for the largest companies are at fairly extreme levels. The relative valuation metrics of the 25 largest companies are at levels that indicate these companies are very inexpensive when compared to other stocks.

As you can see from Figure 2 below, the Relative Dividend Yield of the 25 largest companies in the S&P 500 is at the highest level it has been in more than 20 years.

Figure 2 – Relative Dividend Yield of the 25 Largest S&P 500 Companies

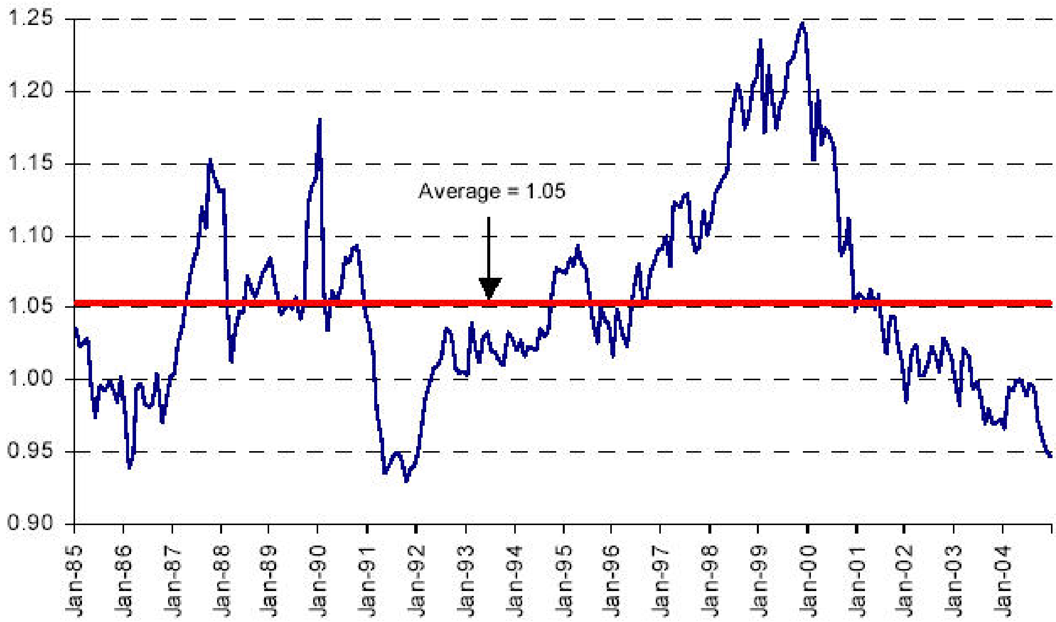


Based on current constituents

Source: FactSet and Smith Barney U.S. Equity Strategy

The same extreme reading is evident in the Relative P/E ratio that is illustrated in Figure 3.

Figure 3 – Relative P/E Multiple of 25 Largest S&P 500 Companies



Relative to the S&P 500, P/E calculated based on FY1 EPS and based on current S&P 500 constituents

Source: Smith Barney U.S. Equity Strategy and FactSet

These observations are very interesting to us. Obviously, as a Large Cap manager, we are excited to see our universe of stocks at more reasonable valuations than other areas of the markets. We believe this will allow us to continue to be able to find excellent ideas in our universe and allow us to earn solid returns for you and our other investors.

We are excited about what 2005 is going to bring. Please let us know what we can do to serve you better.

All my best,

Christopher Alan Zook
Chairman and Chief Investment Officer