HAMRICK INVESTMENT COUNSEL LLC

POLITICAL, ECONOMIC AND CAPITAL MARKETS
REVIEW & OUTLOOK FOR 2005

Political Commentary

In our previous Outlooks for years 2003 and 2004, we identified the following political and economic trends:

- That the United States would get bogged down in a troubled military occupation in Iraq;
- That the Bush Administration would likely be reelected, along with Republican majorities in both houses of Congress;
- That in 2005-2006, widening imbalances and tensions due to U.S. domestic fiscal policy and global political and economic policies will create turbulent investment markets, as well as increasing risk of a major global crisis; and
- That the longer term outlook for the world is for economic growth and increasingly global orientation.

In addition, as expected, equity markets – domestic and foreign – performed well in both years. The value of the U.S. dollar relative to other currencies has continued to depreciate. Short term interest rates and inflation have risen modestly. Longer term interest rates, however, have remained remarkably low, less than our expectations, although we have seen some increase during the latter half of 2004.

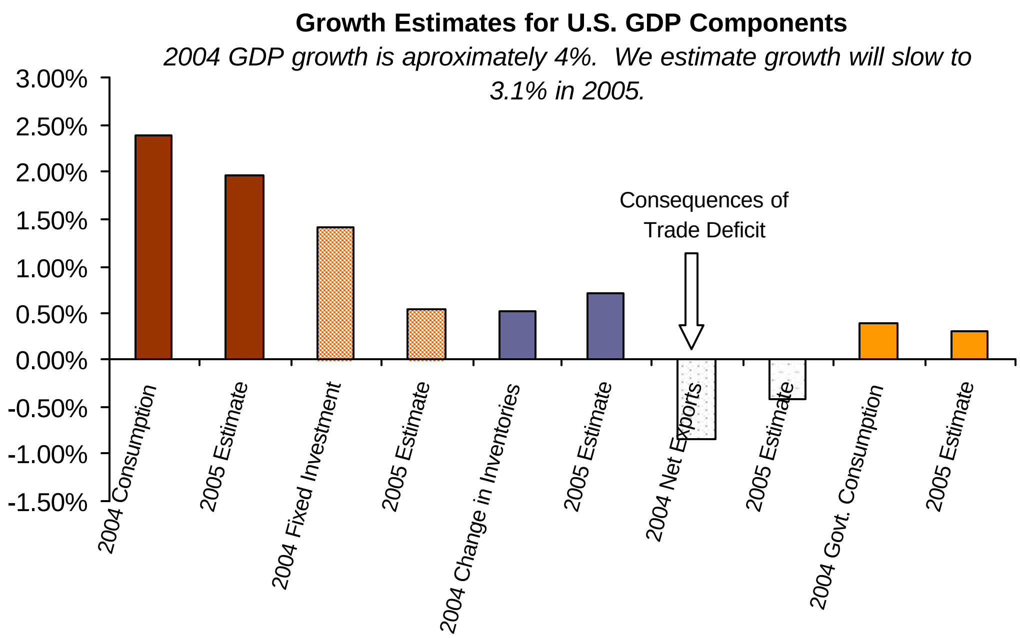
What stands out amongst our expectations is that of turbulent markets in 2005 – 2006, and increasing risk of a major global crisis. As we now look out into 2005 and beyond, do we still expect a crisis? If so, what might occur? How might the investment markets react? What kind of investment strategy do we propose in the face of such expectations?

To begin our analysis, we start with a review of current economic conditions and how we think they may unfold going forward. Next, we take a look at the crisis scenario and our thoughts with regard to it. Finally, we lay out our current investment approach in light of such expectations that we intend to pursue on behalf of our clients.

Economic Review

Below are growth estimates for the individual components of U.S. Gross Domestic Product (GDP) for 2004 and 2005. We expect high oil prices, high levels of personal debt and rising interest rates will constrain personal consumption and investment in equipment and software in

2005. We estimate real U.S. GDP growth for year 2005 at 3.1%, a slower growth rate than 4% achieved in 2004, but still a favorable climate for investments.



Growth in developed countries was also positive in 2004, averaging 2.3%; emerging markets were generally even stronger, averaging 6.3%. Based on recent forecasts we anticipate that strength in most foreign economies will continue in 2005, though at a somewhat slower pace, similar to our domestic economic expectations.

Disturbing Underlying Economic Trends

These projections of ongoing economic growth, despite modest slowdown, appear favorable. However, economic trends underlying these growth rates are troubling. In particular, we are concerned about the U.S. balance of trade and the U.S. federal government budget deficit. These "twin deficits," which are currently receiving considerable attention in the press, are extraordinarily high. The federal budget deficit for 2004 will be about $500 billion, or 4% of GDP, while the trade deficit will be approximately $600 billion, or 5% of GDP, exceeding the record 3.4% of GDP that occurred in 1987. And we expect both will get worse in 2005.

In essence, U.S. consumers are sending dollars abroad to purchase goods and services from foreign producers. Foreigners are purchasing much less goods and services in return. Instead, they have been using their accumulating dollar holdings to purchase U.S. Treasury securities. In effect, they are loaning those dollars back to the U.S. Government to finance its large deficits. The U.S. is becoming increasingly dependent on our foreigner creditors, while foreigners are becoming increasingly nervous about the level and value of their U.S. holdings. If foreigners lose faith in the dollar, a crash could occur, triggering global financial pandemonium.

As an alternative to this scenario, might these deficits turn around and contract?

The “Twin Deficits”

Improvement in any of the following variables could help to restore a healthier balance of trade. The personal saving rate in the U.S. is quite low, but could be promoted to restrain imports. If the U.S. dollar is allowed to depreciate slowly, foreign goods would be more expensive for U.S. consumers, while U.S. exports would be more attractive to foreigners, narrowing the trade gap. Higher productivity in the U.S. or faster economic growth in its largest trading partners, Canada, China, Mexico, and Japan, could also boost exports. In addition, strength in the U.S. economy and sound fiscal policy could help reduce the wide federal budget deficit.

Despite these possibilities for improvement, we are skeptical. Efforts to develop new savings incentives are unlikely to have much impact on the trade deficit in 2005. Foreign monetary authorities are expressing increasing concern about weakness in the U.S. dollar. Further depreciation could easily trigger a crisis of confidence. U.S. companies are shifting manufacturing offshore, which crimps the benefit from any increase in domestic productivity, while foreign economic growth is largely dependent on increased exports to the U.S. Finally, while the U.S. government expresses concern about budget deficits, it continues to pursue policies that are certain to exacerbate them.

The Crisis Scenario

While the trade and federal budget deficits are high, the U.S. is not yet on the brink of crisis. Nevertheless, the current path is clearly unsustainable. Although the timing is uncertain, if no changes occur we think a financial crisis is inevitable.

This prospect of economic crisis is clearly disturbing. Political risks are equally unsettling. Nevertheless, we believe that a global crisis – devastating as it would be – may actually be of less concern than might at first appear. First, in the event of a panic such as a run on the U.S. dollar, we suspect that such a crisis would not last long. Policy makers are now much more knowledgeable about economics and financial markets than they were, for example, at the time of the Great Depression. Many leaders would quickly come forward to address it. It is strongly in the interests of all the major participants around the globe to resolve such a situation.

Next, we note that such a crisis would not necessarily be negative for the markets. The current global imbalances parallel those of the early 1970’s when the Bretton Woods gold-based monetary system collapsed. Ironically, the Dow Jones Industrial Average only declined 7% at the time, but soon went on to reach new highs in the months that followed (although general market weakness prevailed in subsequent years).

Globalization

Finally, we believe such a crisis would not be a sign of deterioration in the global world order. Instead, we view widening U.S. trade imbalances as indications of growing pains in a world that is becoming increasingly more global. Whatever turbulence or crisis that lies before us might actually function as a catalyst towards global structural changes that are already underway.

It is this underlying trend of globalization that we believe is of greatest significance. Therefore, it forms the basis for our current investment strategy.

Investment Philosophy and Strategy

Given the near term outlook of turbulence and potential crisis, yet the overarching trend of a more interdependent global society, what is our recommended strategy? Here, too, our outlook has not changed substantially.

Diversification

Without question, our primary investment theme is that of diversification. We recognize that we don't know the future. In this uncertain world, diversification is the paramount successful strategy. We serve our clients best by holding a broad array of investments: large and small cap stocks of domestic and foreign companies, fixed income investments of all types, real estate-related securities, cash – all will remain components in client portfolios.

To Hedge, or Not to Hedge?

The prospective scenario of crisis that we have been evaluating – though uncomfortable to contemplate – is not unique to our outlook. A growing number of economists and analysts have been expressing similar concerns. In the past few years, hedge funds and other aggressive hedging strategies, such as short sales, put options and other alternative investments, have become increasingly popular. Hedge funds and other hedging strategies are generally based on short term market speculations. They seek to make profits when securities prices go either up or down.

In light of our outlook for market turbulence, uncertain returns and potential weakness over the next two years, we have carefully considered using such strategies in our client portfolios. We recognize the rationale for them. During a time when returns are expected to be weak or negative, investors can protect their portfolios – or even profit handsomely.

Nevertheless, we have chosen not to take this approach. Our reason is that aggressive hedging techniques do not fit with our investment philosophy.

At Hamrick Investment Counsel, our approach is to participate in the rewards of longer term economic growth. We don't seek to profit on market weakness, or undertake short term speculations for our clients. Nor do we seek to make profits from the losses of others.

Near-Term Defensive Strategies

This is not to say, however, that we are ignoring the near term risks that we see in the markets. On the contrary, we are active managers, and we are currently taking steps to protect our clients' portfolios:

(1) Cash. Generally we hold modest cash and money market fund balances in client accounts. Presently we are holding cash balances a few percentage points above our longer term targets. We are not market timers, but these cash balances reduce risk. They act as shock absorbers during periods of market turbulence, and provide us with flexibility to purchase securities at favorable prices in the event of market weakness.

(2) U.S. Treasury Inflation Protected Securities (TIPS). TIPS are U.S. Government obligations that pay modest interest. In addition, their value and interest payments are periodically adjusted to reflect change in the consumer price index. The appeal of these securities is their exceptionally low risk. We find them particularly appropriate in the current market environment, and hold them in nearly all portfolios where they don't create tax problems.

(3) Lower Risk Equities. Currently we favor holding some utilities, petroleum companies and other stocks that pay good dividends and have generally more stable return characteristics. We also hold real estate investment trusts (REITs), although recently we have been trimming them back in response to significant gains they accrued in 2004.

(4) International Securities. Another defensive strategy we use is to hold foreign stocks and bonds. They enhance diversification and provide some benefit for clients in the event of ongoing weakness in the dollar relative to other currencies.

Longer-Term Growth Opportunities

Alongside the above defensive positions, we are concurrently actively pursuing holdings with the goal of longer term growth:

(1) Growth Stocks. For the longer term, we seek out companies in businesses that have good prospects despite current economic weakness. An example is our recent investment in the electronic medical records industry. In seeking out such companies, we evaluate them on several criteria: first, on their financial strength and business prospects. We evaluate their corporate cultures as well: do they have a history of operating with integrity and honesty? How do they treat their employees? Are their executive compensation programs within reason? What are their attitudes towards shareholders and the communities in which they operate? We look for companies that are both good investments and have good human values.

(2) Global Focus. In conjunction with our view that the world is becoming increasingly interdependent, we favor stocks of top quality companies that are progressively adopting a global focus. We recognize that the United States currently dominates the global economy, and that our clients live and function in the U.S. Nevertheless, we believe that the evolution toward a more global world is inevitable, and that the companies that will do best are those that are positioning themselves to operate effectively with that perspective.

(3) Emerging Market Securities. Stock and bond markets in developing countries such as China, Latin America and Southeast Asia can be extraordinarily volatile. At the same time, these economies are growing rapidly, and provide opportunities for higher returns. We

invest in emerging market stocks and bond funds in portfolios of clients who have higher tolerance for risk.

Summary

In summary, there are two key elements in our strategy that we are using for clients in light of our current outlook:

- We are adopting a somewhat defensive stance due to our expectation of market volatility and increasing possibility of significant crisis within the next two years;

- Despite this conservative posture, our emphasis is to look beyond the near term risks. We think that these risks represent significant structural changes towards a world that is becoming increasingly interconnected.

What might this more global world look like? We see current economic and political instabilities as growing pains that reflect a world struggling to evolve to a higher level of civilization: a world that is more democratic, more prosperous and more peaceful -- and in which an ever-increasing number of people take part.

It is also a world that requires stronger global authorities. For example, the world may need a reformed global monetary authority in which a supra-national currency replaces the U.S. dollar as the functional monetary unit. It is becoming increasingly evident that protecting the environment is an issue that concerns everyone. In order to reduce the threat of terrorism, the nations of the world will have to work cooperatively. The issues of poverty, hunger, disease and war are global problems. They require global solutions.

No doubt the United States will continue to play a leading role on the world's economic and political stage. Over time, however, we expect its role will become less dominant; that the U.S. will become one country among many working together to bring about these changes.

The outcome, of course, is uncertain. Nevertheless, on behalf of our clients, our strategy is to invest in this vision of the future.

Roy A. Hamrick, CFA

3 January 2005