

February 9, 2004

We retained our emphasis on tax efficient investing in 2003. For clients with taxable accounts, after-tax and pre-tax returns were closely aligned because of modest portfolio turnover. Patience is the friend of the investor who buys a growing business at a discount to its intrinsic value. The only way to get a chicken from an egg is to wait for the egg to hatch. Smashing it to the ground only creates a mess.

The 2003 annual report includes information on your historical performance, current holdings, relevant tax information, and other supplemental information that we hope you find helpful. We have also included a copy of our ADV Part II. Please review your investment policy statement and be certain to inform us of any material changes in your objectives that may result from your review of this report or any outside factors.

The 2003 year-end client letter gives us the opportunity to share our responses to questions that have recently reached our mailbag.

TAKING STOCK

Why did AAM remain committed to stocks in early 2003 as others were selling?

The first quarter of 2003 provided a grim backdrop for the stock market. Corporate scandals were rampant, terrorism fears were escalating, the war drums in Iraq were beating loudly, it was announced that the television sitcom *Friends* would be brought back for another season, and there was scant evidence of an improving job market. Reflecting this cadre of negative sentiment and cultural decline, the stock market continued a three-year slide that began in March of 2000. The cherry on the sundae of negative investor sentiment was the cumulative melt down of over \$8 trillion in investor capital. These developments were enough to put even the most optimistic investors in a fragile mood and diminish one's hunger for common stocks.

TAKING STOCK CONTINUED

Despite the weak start, the popular averages staged a dramatic rally over the last nine months of the year. It was easy to throw in the towel on the equity asset class in early 2003, but the negative headlines, poor investor sentiment, and dramatic price declines provided the ingredients for an exceptional recovery that surprised many investors who were poorly positioned for a recovery.

A rosy consensus, while comforting to the psyche in the short-term, rarely creates favorable long-term investment results. Conversely, the courage to allocate capital at the time of maximum pain plants the seeds for future wealth creation. AAM's solid performance in 2003 reflected our genuine distaste for the "art" of market timing and confidence in the long-term merits of value investing.

CHOOSE YOUR BATTLES CAREFULLY

How does AAM select specific securities from such a large universe of choices?

To build client portfolios, AAM executes a bottom-up allocation strategy. We look for long-term opportunities that we understand and work to maintain a clinical detachment to short-term events. We analyze public filings, study competitors, and speak to managements. Our capital allocation favors companies with conservative balance sheets, significant free cash-flows, high returns on equity, long-term sales growth, stable operating margins, meaningful insider ownership, and moderate price to earnings ratios relative to future growth prospects.

To the extent that we are able to find companies that meet our criteria for purchase – accounts are fully invested. We sell businesses that reach their intrinsic value from price appreciation or a deterioration in business fundamentals. To the extent that we are unable to uncover new businesses to replace those that are sold – accounts build cash. Timing the market and predicting economic recoveries takes away from this process.

We evaluate three core ingredients to determine whether a security is appealing.

1. Competitive Advantage - Does the company possess inherent competitive advantages? We assess whether the business has a protective moat that can withstand the pounding of the waves of competition.
2. Price - Is the business inexpensive in relation to our assessment of its future free cash flow or asset value? When Howard's young children ask him what he does for a living his reply is generally, "I try to buy dollar bills for seventy-five cents." It was obvious that his son had things figured out when he asked for a dollar in exchange for every seventy-cents in allowance he received.
3. Management - Does management intelligently allocate capital by investing excess cash flow in opportunities above a sensible hurdle rate? In the absence of such opportunities, and to the extent that long-term credit quality is not compromised, management should return excess funds to shareholders.

CHOOSE YOUR BATTLES CAREFULLY CONTINUED

Answering two of the three questions affirmatively is difficult, and finding a business where we hit the tri-ecta is a rarity. This explains our penchant for relatively concentrated portfolios.

We wish we could make our approach more complex – black boxes, fancy algorithms, mathematical formulas, lots of trades, technical indicators, and quick reactions to small pieces of news. Instead, we have focused our professional energies on what we perceive as the more complicated task, making potentially complicated things simple. We believe that a portfolio of businesses trading at a discount to their **current intrinsic value** paired with strong prospects for **future growth in intrinsic value** provides the foundation for successful investing.

TRICK OR TREAT

I've heard the stock market does well in a presidential election year. Is there any truth to this? Shouldn't interest rates stay low in such an environment?

Bill Clinton's 1992 campaign manager, James Carville, concisely summed up the work of numerous econometricians when he insisted, "It's the economy, stupid!"

Economists have long observed that the state of the economy goes a long way in determining if an incumbent president is re-elected. Politicians have taken note. It is not a coincidence that since 1960 real economic growth has been above the thirty-year average in eight out of ten election years. Furthermore, since World War II, U.S. presidential election years have experienced gains in the popular stock indices 93% of the time.

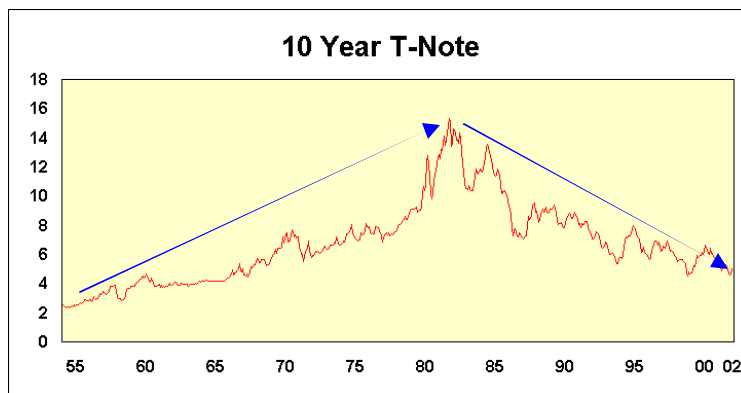
In an effort to gain re-election, politicians generously dole out treats to get voters in the appropriate frame of mind. The current economic expansion was jump-started by aggressive monetary and fiscal policy over the past two years. The Federal Reserve has been drenching the economy with liquidity by maintaining short-term interest rates at a forty-five year low of 1%. In addition, the President and Congress provided a ten-year \$1.7 trillion tax cut at the same time they were spending taxpayer money with unprecedented abandon. In his first three years in office, President Bush has increased non-defense spending by 27% - which is more than LBJ allocated for his "Great Society."

Priming the pump has resulted in economic expansion that has subsequently led to a recovery in corporate earnings. S&P 500 earnings grew by 26% in 2003 — the fast rate in more than a decade.

However, there is the likelihood of a "trick" at the end of this "treat." Once the sugar high wears off, it is highly probable that current aggressive monetary and fiscal policies will lead to a more inflationary climate and higher interest rates.

TRICK OR TREAT CONTINUED

A look at the yield on the 10-year Treasury note since 1955 provides historical context regarding interest rate cycles. From 1955 to the early 1980s, interest rates progressively increased as inflation accelerated and deficit spending took hold. Conversely, during the past 20 years, interest rates have steadily declined as economic globalization diminished pricing power and fiscal responsibility returned to Washington, D.C. We believe that a cycle of synchronized global expansion, mounting deficits, and historically unprecedented monetary stimulus is likely to reverse this cycle.



STOCKING UP

How is AAM allocating client capital based on its expectation for higher interest rates?

Professor Jeremy Siegel of The Wharton School has studied the effects of inflation on various asset classes over two centuries. Siegel found that during periods of rising inflation, all asset classes suffer in the short-term. However, over time, stocks have been the best financial asset in a rising interest rate environment. Intuitively, this makes sense since equities are claims on the earnings of companies that possess the ability to adjust pricing and capital allocation decisions. The ability of stocks to act as inflation hedges over a long-term holding period was demonstrated in the fifty years following World War II. This half century was the most inflationary period in U.S. history, but the real return on stocks exceeded the average of the previous 150 years.

AAM continues to find businesses that meet our investment criteria. The menu is clearly shorter than a year ago but large enough to satisfy the healthy appetite of a fussy eater. We are allocating capital to businesses with pricing power and with the ability to generate large amounts of positive cash flow. Insurance companies like Berkshire Hathaway and payroll companies like ADP with large short-term fixed income investment portfolios are clearly favorable selections. These companies will generate greater interest income in a rising interest rate environment.

Technology and biotechnology companies that meet our valuation criteria are also appealing in controlled doses. Business spending is just starting to accelerate and the benefit to the earnings for companies in these sectors has yet to be substantively realized.

STOCKING UP CONTINUED

We also admit to being attracted because of the skepticism of the business press — the same soothsayers who were fawning over public shells with technology sounding names in 2000. Finally, in an environment of rising interest rates technology companies have historically fared quite well. Stay tuned.

FIXING FOR A BRUISING

Fixed income investments (aka Bonds) for the retail investor are not likely to be interesting places to invest large amounts of new capital in the short-run. In fact, we believe the probability of a negative total return is high for long duration bond investments. Under such a scenario, the price decline in bonds would trump the income stream provided by interest payments. High yield bonds, while more attractive than their AAA-rated brethren, no longer carry the same type of allure to us as they did in 2003. The risk premium has declined dramatically over the past year. AAM is remaining close to home at the short-end of the yield curve while we concurrently continue to look at bankruptcy workouts for senior secured debt. Our current emphasis on keeping the average duration short will provide us with liquidity to lock in higher yields down the road.

We have begun accumulating Treasury Inflation Protected Securities (TIPS) for clients who require fixed income exposure. These bonds are issued by the Federal Government and serve as a hedge against rising nominal interest rates. The rate on these securities is fixed. The principal, however, is adjusted for inflation on a semi-annual basis. This inflation-adjusted principal is not paid until the bond matures. At maturity, TIPS will be redeemed at the greater of the inflation-adjusted principal or par amount of the original issue.

REAL ISSUES IN REAL ESTATE?

In high exposure real estate markets, particularly those in and around major cities on the U.S. coasts, rising interest rates may leave investors under water. Property is a highly leveraged asset that is interest rate sensitive. Declining interest rates are largely responsible for the rapid appreciation in real estate prices in certain areas of the country. The average price of a residential home has advanced by over 20% in the last half decade – a record since such figures have been maintained. This rapid appreciation has resulted in real estate prices that are not justified by the underlying metrics. For instance, the after-tax cost of renting is now much more attractive than purchasing a home in some markets.

A low interest rate is to high leverage as cheese is to a mouse. Currently with mortgage rates at historic lows there is lots of cheese – don't get caught in the trap. Clients seeking long-term appreciation should be wary of investment real estate since current prices significantly exceed intrinsic value in many markets.

MUTUALLY UNBENEFICIAL

What is going on with mutual funds? My friends tell me about hedge funds. What is your opinion of these investments?

“Character is higher than intellect.”

-Ralph Waldo Emerson

The \$7 trillion open-ended mutual fund industry has long portrayed itself as a faithful shepherd of investor assets. However, recent revelations of abusive behavior have exposed an industry awash in conflicts of interest and self-dealing. For example, stockbrokers are given kickbacks to push specific funds over others, and large institutional clients traded in and out of mutual funds to the detriment of individual investors. Congressional hearings in November 2003 led one Senator to describe the mutual fund business as “the world’s largest skimming operation.”

If the conflicts of interest are not enough – mutual funds are renowned for their tax inefficiency. Until funds are required to publish after-tax results, they will continue to focus on maximizing pre-tax gains. To be fair, there are a number of excellent mutual fund families available.

The increasing popularity of hedge funds among the retail investment community is also worrisome. Hedge funds are unregulated investment funds that may invest in stocks, bonds, options and futures, short stocks, employ leverage, and make currency bets. Despite their growing popularity, academic studies by economists from M.I.T and Yale have shown that the average hedge fund does not provide net returns above the S&P 500 over time. A mystique and cachet surrounds the industry since hedge funds were once available only to the affluent. As Chris Farrell of *BusinessWeek* magazine observed, “The real appeal of hedge funds is financial snobbery.”

We are wary of the hedge fund industry in general because of their compensation structure, use of leverage, and lack of transparency. Most managers receive a handsome 1-3% of assets under management and an incentive fee equal to 20% of profits above a high-water mark (This contributes significantly to their inability to outperform the popular averages over time). Lucrative upside benefits coupled with the liberal use of leverage have caused many managers to overreach and led to fund implosions after years of successful results.

Transparency is also an issue as hedge funds may invest in illiquid securities without clear valuations. Hedge-fund finances are often opaque, and the lack of openness is an invitation for abuse.

The issues surrounding mutual funds and hedge funds highlight the benefits of your relationship with AAM. We manage separate accounts for each client family. For a fully disclosed fee similar to what mutual funds charge, we create a customized portfolio tailored to the needs and goals of your family and act as your personal CFO for all matters impacting your financial life.

MUTUALLY UNBENEFICIAL CONTINUED

Our focus is on long-term financial performance. We have no incentive to take outsized risks in an effort to achieve incremental returns. Transparency is never an issue. You have access to your account at all times, and you know exactly what you own, when it was bought, and when it was sold.

FINANCIAL CHECKLIST

What are some tax considerations for 2004?

Economist John Maynard Keynes once noted, "The minimization of taxes is the only intellectual pursuit that still carries any reward." In this spirit, and within the context of the changes to the tax code, we point you to three important tax-planning items for 2004.

1. Estate Taxes: The federal estate tax exemption for an individual is now \$1.5 million in 2004. Be careful because many states still have lower threshold amounts. You must have your asset accounts registered properly and your IRA/Pension beneficiaries coordinated accordingly to maximize the assets that stay in your family and out of the hands of the IRS. Please let us know if you would like a review of your current estate plan.

2. Retirement Accounts: The maximum employee contribution for 401k and 403b accounts has been increased from \$12 thousand to \$13 thousand. Taxpayers who are at least age 50 before the end of 2004 can increase their contribution limits by an additional \$3 thousand. If you are not covered by a retirement plan at work, you may want to consider tax-sheltered vehicles like Traditional or Roth IRAs. We encourage all eligible clients to maximize their contributions to available retirement plans.

3. Dividends and Capital Gains: Taxes on qualified dividends and capital gains were both lowered in 2003, and are now both taxed at 15% for those who are above the two lowest tax brackets. This change makes stocks relatively more attractive vis-à-vis REITs and corporate bonds whose income distributions are taxed as normal income.

This change in tax rates reduces the attractiveness of tax-deferred plans for non-dividend and low-dividend paying stocks. Based on the new tax schedule, long-term holdings may be more appropriate in taxable accounts. When these positions are sold from a taxable account, they will be taxed at 15% capital gains rate. In contrast, distributions from tax-deferred plans are taxed as ordinary income, which currently ranges between 25%-35% for the top four brackets.

IN CONCLUSION

Last Spring, in the depths of the market's decline, we made important allocations of capital into businesses that have yielded significant profit. We were shooting fish in a barrel. Our batting average is certain to be lower in 2004. Our goal is to make enough contact to win the game and keep your capital growing while managing risk.

IN CONCLUSION CONTINUED

At world headquarters, we have been investing in our business. We have a new technology platform, a more robust website, and an additional build out of space to accommodate our existing business team and future additions.

We are pleased to share with you that George Andresen has been promoted to Executive Vice-President of Operations, Trading, and Technology. His efforts over the past six years and the opportunities that stand before us make him the right person for this expanded role.

We encourage you to log on to www.alterasset.com and to utilize the resources that it offers from individual portfolio information to updates on tax law changes. You can also view consolidated accounts. This service allows you to see all available online accounts whether they are with AAM or not. You have complete control over who can view this information. Beginning in the second quarter of 2004 you will find regularly updated commentary on individual businesses held in client portfolios on the site.

If this is not enough of an enticement, getting your log-on I.D. and password by March 1st will qualify you to be in a drawing for a charitable contribution of \$1,000 to be made in your honor to an unrelated registered charity of your choosing.

We appreciate the very special relationship we have with our client families. AAM is now twelve years old with the energy and enthusiasm of a young nimble organization and the experience of navigating successfully through a long and severe bear market.

The work we do for our client families and institutions each day keeps us extremely enthused and motivated. For those of you who have been with AAM from the beginning, we cherish your early confidence. For those who have joined the AAM community more recently, we welcome the chance to work with you on the opportunities and challenges that lie ahead.

The mid-year update will be mailed in July. In the interim, we look forward to talking to and visiting with you.

On to the opportunities that are before us!

Best Regards,



Howard



Steve



George