ALTER ASSET MANAGEMENT, INC.

August 3, 2005

"The hours of folly are measured by the clock, but of wisdom no clock can measure."
-William Blake-

Dear Friends of AAM,

Nothing seems to ignite passions lately quite like a hot little stucco sided single-family home with multiple bidders. Based on returns over the past five years, people have a right to be giddy about real estate. After all, the median U.S. home has jumped a stunning 55 percent according to the National Association of Realtors (NAR). Some individual markets are sizzling. For example, prices of single-family homes in the Los Angeles area have gone up 135 percent over this period. In many other coastal cities and in Las Vegas, appreciation has well exceeded 100 percent. In contrast, the broader stock market indices are still trading below their highs from early 2000.

For the first six months of 2005, the equity market has fluctuated in a narrow band between gains and losses and the S&P 500 and Dow Jones Industrial Average ended in the red with price declines of 1.7 percent and 4.7 percent, respectively. Although this listless trading can try one's patience, it is entirely normal for the stock market to remain range bound for periods of time. Returns in the market come in sudden leaps and bounds — a phenomenon which is reflected by the historical fact that just ten trading days can represent half the returns of any given decade.

All of the excitement in real estate and boredom in stocks begs the question — is there trouble brewing on the home front? Are stocks and/or bonds attractive?

The actions of the average investor have been predictable. As real estate prices have risen, more and more people have flocked to put money into real estate with the belief that prices will only go up. Buying real estate at extended valuations and bypassing more liquid and more favorably valued equity investments is, in our view, risky.

The relative stagnation of U.S. equities against a backdrop of rising corporate earnings has made valuations attractive. Specifically, we are finding individual businesses in retail, technology, health care, and the consumer staples sectors that meet our investment criteria and provide a margin of safety.

Financial asset valuations are guided by interest rates much like the planets in our solar system are bound by the gravitational force of the Sun. We will use the mid-year 2005 client letter to offer a logical construct for the valuation of major asset classes including real estate, stocks and fixed income investments based on our assessment of interest rates, investor psychology, and other tools which help us determine asset allocation. In our view, a well-selected portfolio of stocks will outperform both real estate and bonds over the next three to five years.

No AAM client letter is complete without a brief digression. Most readers of our mid-year letter are in the top decile of wealth in the United States. Despite this economic blessing, we must ask ourselves whether or not we in the top decile of happiness and well-being. We will share some recent academic research touching on the relationship between wealth and personal happiness. You can say you heard it here first, wealth can buy happiness!

GREENSPAN UNPLUGGED

In January 2006, Alan Greenspan joins the ranks of the unemployed after a 14-year tenure on the Federal Reserve Board. Many have speculated on a possible successor which led one late-night comic to ponder aloud, "Can you clone Alan Greenspan or does it have to be living tissue?!"

Greenspan has never been known as the life of the party. He has often been accused of being dry, vague, and ambiguous. Nevertheless, his recent testimony on June 9th before the Joint Economic Committee of the U.S. Congress provided insight about the real estate market. He observed:

> *Although a "bubble" in home prices for the nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.*

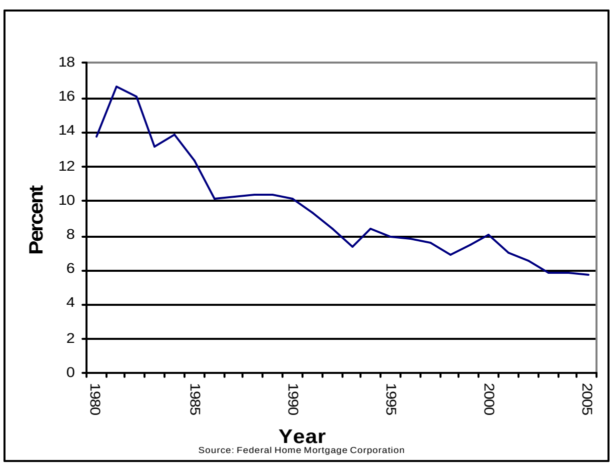
Articles about real estate froth have dominated the cover of almost every major publication in the past couple years. One observer commented that the bubble in media coverage threatened to outpace the actual bubble in the real estate market. This said, what has driven the gains in the real estate market and is it sustainable? Why does Greenspan feel like froth is only limited to some local markets?

THE REAL ESTATE GRAVITY MACHINE

Historically, home prices have risen with a modest premium above inflation. In the past ten years, however, the value of housing has risen 46 percent faster than the general level of prices for goods and services.

Home values have risen as interest rates have fallen and borrowing costs have declined. Over the past 25 years, the interest rate for a 30-year home mortgage has declined to historical lows (Chart 1).

Chart 1: 30-Year Conventional Mortgages



More recently, economists have tried to explain this persistent downward trend in long-term interest rates despite the Federal Reserve's monetary tightening campaign over the past year. Various hypotheses have been developed. Some argue that a worldwide savings glut has compressed long-term yields since savings are being recycled into bonds instead of productive investments.

Demographic shifts may be another reason since aging developed societies like the United States, Japan, and Europe are accumulating fixed income investments for retirement. Global competition also keeps a lid on inflation. China, with an undervalued currency, is exporting deflation to the U.S. everyday.

Despite disagreement about the exact reasons interest rates are low, there's no debate about their impact. Financial assets directly benefit from low rates because borrowing costs are reduced and access to capital is easier. The inverse relationship between asset values and interest rates is apparent in all asset classes. It is most observable in the value of real estate where debt is most readily used to finance purchases.

Many home buyers determine their ability to purchase a house based on their monthly cash flow since mortgage payments are typically made on a monthly basis. For buyers who can only afford a monthly payment of $2,000, for example, we can calculate how much they can borrow based on mortgage rates at different periods since 1981 (Table 1).

Table 1: Loan Amounts in Different Years Based on a $2,000/month Budget

Year	Mortgage Type	Interest Rate	Loan Amount
1981	30-Yr Fixed	16.6%	$143,000
2000	30-Yr Fixed	8.1%	$270,000
2005	30-Yr Fixed	5.7%	$350,000
2005	10-Yr Interest Only	5.5%	$436,000

Table 1 highlights that 30-year mortgage rates have declined from 8.1% to 5.7% from 2000 to 2005. This 30% drop in borrowing costs has had the effect of increasing loan affordability by a similar percentage. A person who was able to borrow $270,000 to purchase a house in 2000 can now manage to carry a mortgage of $350,000.

Another factor that has eased the affordability of real estate is the popularity of innovative – and potentially risky – mortgage products that allow buyers to stretch for more expensive homes. Interest-only products, for example, allow buyers to make smaller monthly payments than conventional mortgages since they are only required to pay interest for a fixed period of time. After the fixed period, rates will typically adjust every six months. Interest-only loans now account for 20% of new mortgages compared with less than 5% in 2003. In hot real estate markets like San Francisco and San Diego, they account for 45% and 48% respectively.

It is not hard to see why interest-only loans are so popular. Currently, an interest-only home buyer can afford a $436,000 loan on a $2,000 per month budget — a 60% increase in loan amount compared to a borrower of a 30-year mortgage in 2000.

The decline in long-term interest rates and the popularity of unconventional financing products goes a long way in explaining why real estate prices on average have increased 55% since 2000, according to the National Association of Realtors. From this perspective, the real estate market as a whole is not unreasonably priced given the current level of rates. As we have seen, just a decline in the level of rates since 2000 would warrant a 30 percent increase in the value of real estate. Mortgages like interest-only loans have given buyers the ability to stretch even further.

What should be worrisome, however, are individual markets where gains have significantly outpaced income growth, inflation, and the effects of easing rates. Froth is evident in select markets where speculators have pushed prices beyond those that are reasonable by market fundamentals. According to the NAR, speculators now account for 10 percent of all homebuyers – twice the historic rate. In areas like Los Angeles, for example, the number of homes sold that had been owned for less than six months jumped 47 percent in 2004. In Las Vegas, flipping – the practice of buying a property with the intent of selling it immediately – has increased five-fold over the past five years. This wave of hot money has pushed valuations to historic highs.

The value of any asset is determined by the discounted free cash-flow it is expected to generate over its useful life. With this in mind, one of the most useful ways to gauge housing valuations is to compare them to rental income. This produces a ratio similar to the price/earnings ratio that we use to gauge stock prices. On average, home prices are at historically high valuation levels relative to rents as highlighted in Chart 2.

Chart 2: U.S. Price to Rent Ratio from 1982

Federal Reserve Bank of San Francisco

It appears that many U.S. housing markets have gotten ahead of themselves. These prices may be justified if long-term interest rates continue to fall dramatically in tandem with a strong economic backdrop. In our view this is the lowest probability scenario. When will the music stop? As in every speculative period, it will only be clear in retrospect.

<u>LOVE THE ONE YOU'RE WITH</u>

With their hit song "Love The One You're With," *Crosby, Stills, Nash, & Young* implored individuals to stop comparing their current companions to old flames. The lesson: accept what you have and enjoy it.

Fortunately, people do not need to be so accepting when it comes to their investments. We are free to compare and to choose what assets we want and do not want for our portfolios. Rational investors must make decisions between available opportunities. We have observed the current state of real estate, and we now turn our attention to bond and stock investments.

Just over a year ago, people joked that "cash was trash" as yields on money market funds were below 1 percent. After nine quarter-point hikes by the Federal Reserve since 2004, the federal-funds rate is now at 3.25 percent. By way of a practical and positive example, companies such as Berkshire Hathaway and Microsoft have large cash hoards and their earnings will clearly benefit from higher short-term interest rates.

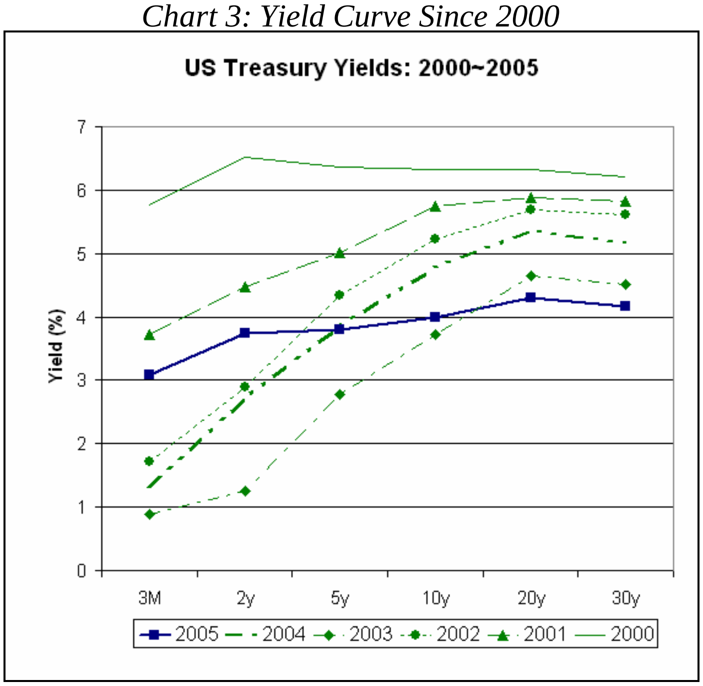
While the Fed Funds rate has risen more then four-fold, long-term rates as represented by the 10-year Treasury note have declined by almost 20 percent from 4.9 percent to approximately 4 percent. The result has been a flattening of the yield curve (Chart 3), which shows the interest rate yield for different maturity dates. Typically, investors are rewarded with higher rates for longer term bonds. AAM has largely limited its fixed income commitments to short-term instruments as:

1) We are not compensated for the additional time horizon in the form of materially greater income.

2) Longer term bonds have higher price volatility. As interest rates rise, their prices decline.

3) A short duration portfolio allows us to roll over mature bonds at what we expect will be increasingly attractive rates.

Chart 3: Yield Curve Since 2000

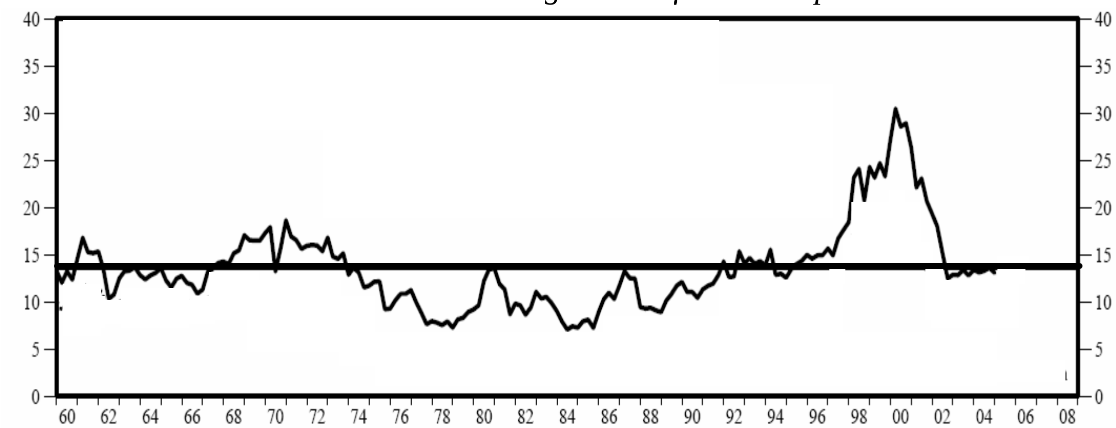


While we continue to seek out opportunities in high-yield debt, the available options have become less attractive and more competitive. As a result, present activity has diminished in this space.

STOCK UP ON A MARGIN OF SAFETY

On an absolute level, the U.S. equity market appears to be reasonably priced and inline with historical valuations. Chart 4 provides a forty-five year look at the current price-to- earnings ratio of U.S. companies.

Chart 4: Price to Earnings Ratio of U.S. Companies

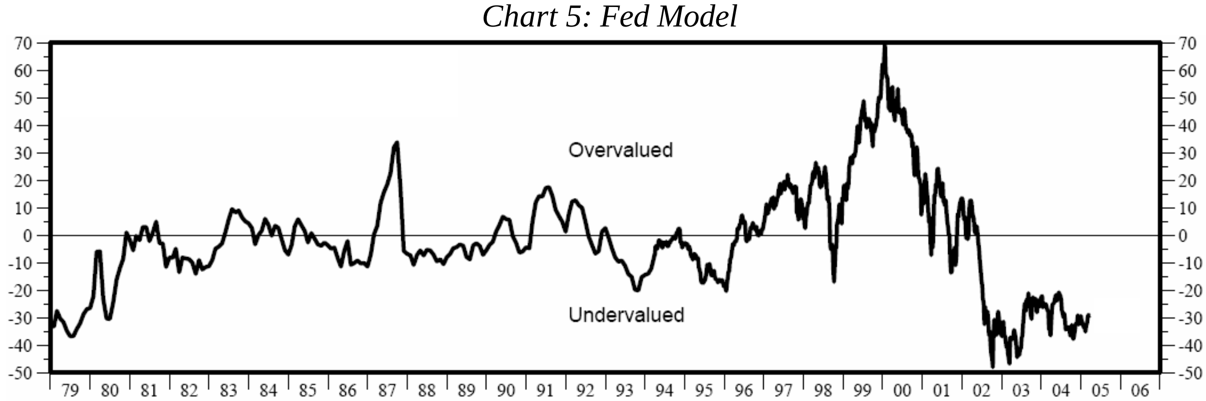


Source: Edward Yardeni

The stock market as represented by the S&P 500 continues to be undervalued relative to bonds as measured by the "Fed Model" (Chart 5). We first highlighted this useful tool in our 2003 mid-year letter at a time when we made a case for stock investments after the 3-year equity bear market that began in 2000.

The Fed Model measures the correlation between the yield on the 10-year U.S. Treasury note and the earnings yield on the S&P 500. When the S&P 500 earnings yield is above that of the U.S. Treasury note, stocks are relatively undervalued vis-à-vis their risk free fixed income counterparts. There are two ways for the markets to achieve equilibrium. Either the yield on the 10-year Treasury rises and bonds fall in price, or stocks gain in price. Although the market as whole is undervalued we believe a combination of equity appreciation and a rise in long-term interest rates will restore equilibrium over the next several years.

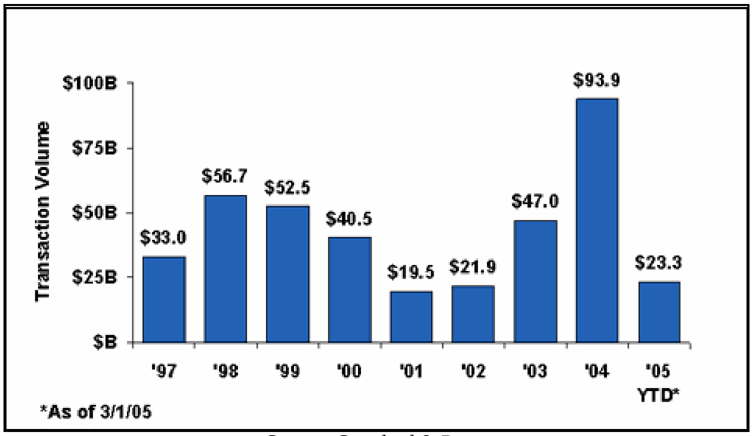
Chart 5: Fed Model



Source: Edward Yardeni

Other signs that stocks may be cheaper than bonds can be seen in the rise of buyout activity where investors use debt to finance the purchase of equity. Over the past three years, private acquisitions of public companies have doubled. Leveraged buyout (LBO) activity as a whole has soared to nearly $94 billion in 2004 compared to a low of $19.5 billion in 2001 (Chart 5). 2005 is on pace to be another big year for LBO transactions with the first quarter seeing over $23 billion in deals.

Chart 6: Annual Leveraged Buyout Transaction Volume: 1997-2005



Source: Standard & Poors

Even one of the largest buyers of U.S. debt, China, has started casting about the U.S. equity market. Recent high-profile bids for Maytag from China's Qingdao Haier and for Unocal from China's Cnooc may reflect relatively more attractive U.S. stock prices relative to debt.

CONCLUSION

We continue to retain a constructive outlook on U.S. equities relative to most other asset classes. Variables such as fluctuations in the dollar, the potential for terrorism, and unpredictable energy prices all affect short-term asset pricing. Interest rates and investor psychology, however, are providing us with an intermediate-term compass that guides current capital allocation decisions. Within this framework, our individual security selections will continue to be driven by our ability to competently assess the margin of safety of corporate equity and debt.

We would like to take a commercial moment and veer slightly away from pure capitalism to discuss capitalism's impact on human happiness.

We'd all like to think that the capital we earn from our professional efforts buys happiness. A recent paper entitled "How Not to Buy Happiness," by Professor Robert Frank of Cornell's Johnson School of Management finds that humanity's unparalleled ability to adapt renders increases in conspicuous consumption unable to permanently increase happiness. Considerable evidence suggests that if we use an increase in our incomes simply to buy bigger houses and more expensive cars, then we do not end up any happier than before. In fact, life often gets more complicated in some very unpleasant ways. The human ability to adjust is remarkable. As we work harder to buy shinier toys, we become increasingly desensitized to their perceived merit.

Frank observes that if we use increases in incomes to buy inconspicuous goods – such as freedom from a long commute or a stressful job – then the evidence paints a very different picture. The less we spend on conspicuous consumption goods, the more time we can devote to family, friends, exercise, sleep, travel, and other restorative activities. Reallocating our time and money in these and similar ways result in healthier, longer, and happier lives.

To this end, we feel fortunate to have built relationships with client families whom we admire and respect. (Howard's note: To no greater extent were the benefits of such an environment prevalent then during the illness of my dear mother whose life ended in early July. There are no appropriate words to describe the support received from friends and family. Thank you.) We have a corporate culture that respects family time and community involvement. We are honored by your trust, and driven to succeed by our love of an environment that allows us to grow and challenges us intellectually.

We recently achieved new benchmarks in assets under management and client relationships. With this in mind, we continue to attract exceptional new team members.

We are pleased to welcome Paige Cutrona to the AAM family as an Operations Associate. If you call, you will be treated to a wonderful voice on the other end. Paige is an accomplished classically trained singer, having performed with the New York Philharmonic, the New Jersey and Tucson Symphonies and the Royal Concertgebouw and Royal Philharmonic Orchestras. Paige currently performs with The Princeton Festival and The New Jersey Opera Theater. She received her B.A. at Westminster Choir College in Princeton, and a Masters in Voice Performance from Carnegie Mellon University (We are trying to convince her to take Steve's place on AAM's karaoke team).

In addition to AAM's privacy policy, a copy of our Form ADV II is included for your review. The year-end client books with tax information will be mailed by the end of February 2006.

That's all for now. Enjoy the rest of your summer. We look forward to speaking with you soon.

Best wishes,

Howard Stephen George