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CHARTWELL REVIEW

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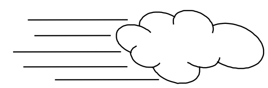
A Cloud of Dust



Our theme this quarter echoes the football expression for plodding, conservative progress toward the goal line, as in "3 yards and a cloud of dust". This year's low return and low volatility environment in most investment markets has required careful attention to "blocking and tackling", but with little payback. And make no mistake about the very low volatility environment we've been in - over the past 200 trading days (about 41 weeks) the S&P 500 has been max up 4.5% and max down 4.5%. There have been only 4 such periods with return variance this low in the past 34 years, most recently 1993.

Alternatively, our title could refer to the current Presidential campaign (okay, this is a weak transition but every review this time of year comments on the election). Some people feel this Presidential election is the "most important in a generation", which seems like more hype than really necessary. But, there's no getting around the fact that a whole bunch of reasonable people are finding a lot of stuff to reasonably disagree with one another about. As investment advisors, we were struck by the following statistics:- since 1945, average annual stock market performance during all Republican administrations has averaged +8.2%, but +9.1% during Democratic ones. Most on Wall Street are surprised by those figures, although the difference seems too small to have much predictive value one way or the other. *However*, stock market returns under all Republican-controlled Congresses has averaged 16.6% (irrespective of the President's affiliation), but only 6.8% under Democratic-controlled Congresses. Perhaps we're all focusing on the wrong elections (pop quiz – are any of your Senators and Congressmen up for re-election, and if so, who are their opponents?).

Table 1. Index Benchmarks

Market Index	Q3 2004	Trailing Returns * 1Yr	3Yr	5Yr	10 Yr
S&P 500	(1.9)	13.9	4.1	(1.3)	11.1
U.S. Large-cap Stocks	(2.2)	11.7	2.0	(3.4)	10.8
U.S. Mid-cap Stocks	(0.8)	20.6	13.3	8.3	12.8
U.S. Small-cap Stocks	(2.9)	18.8	13.7	7.4	9.9
International Stocks	(0.2)	22.5	9.5	(0.6)	4.3
T-bills (3 month)	0.1	1.0	1.7	3.2	4.2
1-3 Year Treasuries	1.0	1.1	3.1	5.1	5.6
Aggregate Bonds	3.2	3.7	5.9	7.5	7.7
High Yield Bonds	4.5	11.9	13.0	6.5	7.6
Global Bonds, ½ hedged	2.9	5.6	8.8	7.2	7.7
CPI, **annualized**	0.4	2.4	2.1	2.5	2.4

* Annualized trailing returns for periods ending 9/30/04.

Table 2. Average Fund Returns

Fund Category	Q3 2004	Trailing Returns * 1Yr	3Yr	5Yr	10Yr
U.S. Large-cap	(2.4)	12.5	3.7	(0.6)	9.7
U.S. Mid-cap	(2.6)	16.2	9.1	5.7	11.4
U.S. Small-cap	(3.2)	17.8	12.9	9.8	11.8
International Lg. Cap	0.0	20.4	9.6	1.1	5.7
International Sm. Cap	(0.1)	25.4	20.3	7.6	8.6
Emerg. Mkt. Equity	8.3	25.6	24.1	8.0	1.7
Balanced/Hybrid	(0.1)	9.3	5.2	3.3	8.5
General Bond	3.1	3.6	5.6	7.0	7.2
Government Bond	2.5	2.7	4.5	6.3	6.6
High Yield Bond	4.1	11.4	11.1	5.0	6.3
Hedge Funds Index	*0.4*	*9.1*	*8.4*	*9.5*	*10.7*

* Annualized trailing returns for periods ending 9/30/04.
Source of fund's data: Morningstar; Hennessee

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Is it Fourth and 10 For Our Economy?

In late September, we learned that our domestic economy grew at an annual rate of 3.3% during the second quarter, a figure revised up from the 2.8% previous estimate, but still well below the 4.5% growth rate for the first quarter. In fact, it represented the slowest rate of growth since Q1 of 2003.

Table 3. Contributions to Second Quarter GDP

Factor	Contributed …	…By Rising
Personal Consumption	**1.10%**	**1.6%**
Fixed Investment	**2.07**	**13.9**
(- by Businesses	*1.21*	*12.5)*
(- by Consumers	*0.86*	*16.5)*
Chg. in Inventories	**0.78**	**na**
Exports	**0.70**	**7.3**
Imports	**(1.77)**	**12.6**
Government Spending	**0.41**	**2.2**
Real GDP Growth	**3.3%**	

Despite the final upward revision, the quarter's growth rate was more than 1% below prior estimates. Perhaps as a result, the consensus among economists for 3rd and 4th quarter GDP growth has again been lowered, to 4.0% and 3.8%, respectively. In January, estimates had been 0.5% higher in each case. Next year's growth is also forecast to be lower, at 3.5%. These expectations all remain more favorable than our average actual experience over the past three years, even as they point to reduced growth expectations. The downward glide path we seem to be on makes it more important to appreciate the parts of our economy a bit better. Table 3 reviews the components of the quarter's growth.

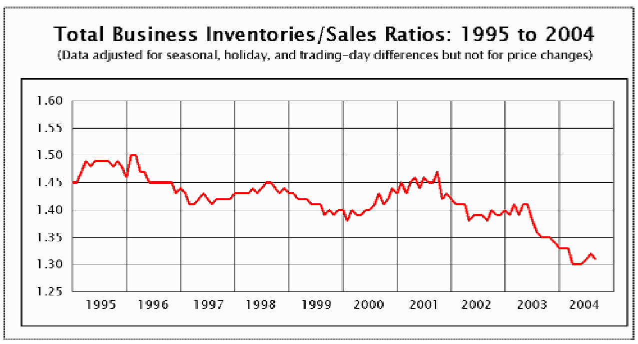
Consumer spending – The biggest contributor to the 2nd quarter slowdown was weak personal spending growth. The 1.6% real increase was the lowest figure since the middle of the recession in 2001. As noted last quarter, real average weekly earnings declined for five straight months through June, and real wage growth has historically been highly correlated with consumer spending growth. Thus, reports of month-over-month increases in real wages of 1.0% and 0.3% for July and August gave investors hope that consumer spending would rebound, even though September saw no change (0.2% nominal growth was offset by 0.2% of inflation).

What hasn't been weak is residential fixed investment, which means spending for housing, where a very robust 16.5% annualized increase in the second quarter was the tenth consecutive quarterly advance. Over the past three years, this area of our economy has grown at a real annual rate of 8.0%.

Business Spending – nonresidential fixed investment (business spending on property, plant and equipment) was up 12.5% in the 2nd quarter. After declining nine consecutive quarters through the first quarter of 2003, this major economic category has increased at an 11% average annual rate during the last 5 quarters, thereby adding over 1% to our GDP's annual growth rate. The forward-looking issue with this stat is whether firms see the need to continue aggressive investment spending, or cut back. On this score, we think the data is mixed. Industrial production rose only 0.7% in the third quarter, and has been on a decelerating trend throughout the year. Despite the slow down, total industry capacity utilization rose to 77.2% in the third quarter, up from 74.9% one year ago. Capacity has increased only 1.5% over the past year, as business spending has been focused on enhancing productivity.

The other major element of business spending is inventory replenishment. This has added 0.75% to GDP growth over the past four quarters, and inventory levels at the end of August were up 8% in nominal terms from August 2003. Inventory growth was a little faster than sales growth during the 3rd quarter, as the following chart reflects, but overall inventory/sales ratios remain very low in historical terms (suggesting the risk of inventory cutbacks is not very high over the near-term).

Chart 1. Business Inventories are Under Control



International trade – Our GDP growth rate was 1.1% lower during the second quarter because of our ongoing trade deficits. This can be expected to worsen for the 3rd quarter, as the 90-day moving average of the deficit is on track to rise to $54Bn/month in September, up from "just" $50Bn at the end of June. The related current-account deficit hit a record 5.7% of GDP at the end of the 2nd quarter. Recent trends in this area are not encouraging – not only do monthly imports exceed exports by record amounts, but imports are persistently growing faster. Thus, the monthly moving average of net imports was $36Bn in August 2002, but $54Bn for August 2004. The total trade deficit for 2004 will exceed $600Bn, up from $421Bn in 2002.

Employment growth – The third quarter started with news that payroll jobs increased by only 112,000 in June, which had the effect of convincing many investors their growth projections for the remainder of 2004 were too optimistic. Based on household survey data, the economy added 450,000 fresh workers in the third quarter, including the loss of 180,000 workers in September. Based on payroll data, employment was up just 310,000 in the quarter, including a low 96,000 gain in September. The wildcard in these numbers is the weather. It's too early to conclude with any certainty the impact from the series of hurricanes that hit the U.S. during the quarter. Nonetheless, employment growth this year has clearly been more modest than original expectations, putting that much more emphasis on real wage and salary growth to support consumer spending.

The inflation picture – General price inflation slowed down in the third quarter across all levels of our economy (consumer, producer, and import) following a very disconcerting period of accelerating prices during the first half of 2004. For the 3 months ended in September, consumer prices (including energy) were reported to have increased at an annual rate of only 0.6%, after increasing at a 5.0% annual rate during the first six months of the year. Energy costs temporarily declined in the quarter, having increased at annual rates exceeding 35% in the year's first half.

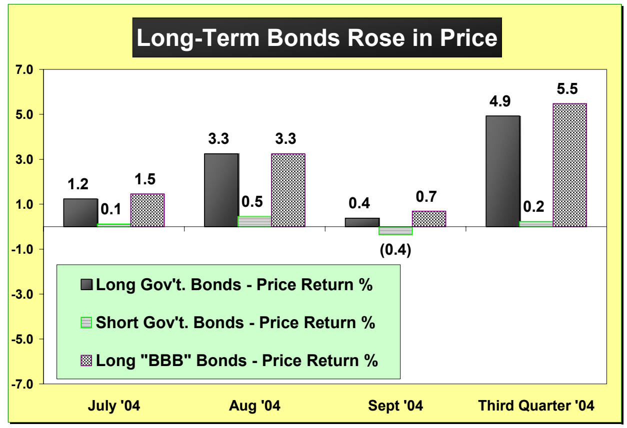
Thus, the rise in "all item" CPI since September 2003 is estimated to be just 2.5%, including a 24% increase in fuel oil, a 10% increase in gasoline, and just a 2.8% increase in housing costs. According to the government, costs of motor vehicles, public transportation, household furnishings, and apparel, have all declined.

Prices for all imports rose 2.0% during the 3rd quarter, which translates into an 8.3% annualized rate, because petroleum import prices rose over 11% (a 53% annualized rate). Non-petroleum import prices have risen only 2.9% over the past year.

The Bond Market Scores Points

The domestic bond market surprised many fixed income investors and their managers during the third quarter. With future inflation expectations having been raised over the past year, and the Fed in the early stages of a cyclical tightening phase (evidenced by the increasing Fed Funds rate), few thought that prices for longer-term bonds would be rising. Yet, that is just what occurred during the quarter. In what insiders refer to as a "bull flattening" of the yield curve, short term rates went up in tandem with the increased Fed Fund's rate, but long-term bond yields dropped by over 50 bps.

Chart 2. Long-term Bond Prices Rose in the Quarter



So, while the Fed Funds rate was being raised from 1% to 1.75% by quarter's end, the 10-year Treasury bond's yield was falling from 4.62% on June 30th, to just 4.12% at the end of the third quarter. Thus, the "yield curve" flattened by 1.25% in just three months, which represents an extraordinary shift. The result was an environment that clearly favored portfolios which were "long" duration as the quarter began (few and far between, from our conversations with managers), but also favored those who had "bulleted" their interest rate risk by concentrating on medium term securities rather than a combination of short + long.

The other primary bond dynamic – credit risk, was again a positive factor during the third quarter, especially in the very long maturities. Prices on long-dated credit bonds rated "A" or below, rose more than equivalent maturity government bonds. This, plus inherently higher coupon income, ultimately favored strategies which overweighted long-term corporates.

Table 4. Fixed Income Sector Returns

Periods ended September 30, 2004; indices are cap-weighted

Index (% of Aggregate)	3Q04	1 Yr.	3 Yrs.
Aggregate Bonds *(100%)*	**3.2**	**3.7**	**5.9**
US Gov't, all *(36%)*	3.1	2.5	5.3
- US Treas, long (6%)	*6.4*	*5.0*	*7.6*
Mortgages *(35%)*	2.6	4.4	5.1
Inv. Grade Credit *(25%)*	4.2	4.4	7.7
- "BBB" Bonds (10%)	*4.8*	*5.8*	*8.7*
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High Yield Bonds, all	4.6	12.4	12.2
- "B" Bonds	*4.8*	*12.4*	*13.2*
Global Bonds, Unhedged	3.3	7.0	10.6
Global Bonds, Hedged	2.6	2.9	4.4
Emerging Market Bonds	9.4	12.0	15.8

U.S. Equities – Three Downs and Out?

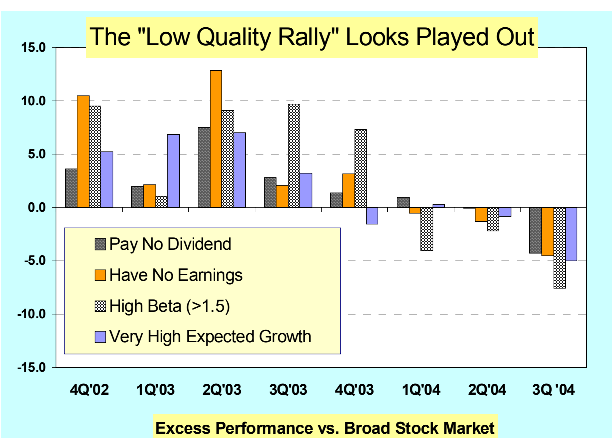
The broad S&P 500 index of companies ended the third quarter with a value of 1115, down modestly from its second quarter close at 1141. It was the first negative quarter for the broad market since we invaded Iraq in the first quarter of 2003. On October 9th, the current bull market observed its 2nd anniversary. The date dovetails nicely with calendar quarters, so we've revised Table 5 to provide us some insight to this recovery's patterns.

Table 5. U.S. Equity Returns by Style/Market Cap

Periods ended 9/30/04; indices are cap-weighted	3Q 2004	Y-t-d 2004	2 Years	3 Years
Growth				
Large Cap	(5.5)	(3.7)	14.1	(0.3)
Mid Cap	(4.3)	1.3	25.7	10.1
Small Cap	(6.0)	(0.7)	28.7	9.1
Value				
Large Cap	1.5	4.0	20.5	4.4
Mid Cap	1.7	9.0	26.9	15.1
Small Cap	0.2	8.0	28.7	17.7

Market cap/style sector emphasis has played a very important role in this two year bull market, since the rising tide has definitely favored small/mid cap and value stocks (in that order). While the two-year recovery has been very potent, with cumulative returns of 30-65%, most cap/style sectors have taken a decided breather in 2004. Only small/mid-cap value stocks have continued to advance this year.

Chart 3. Equity Investors Embrace "Fundamentals"



As Chart 3 reflects, the first year of this bull market could rightfully be described as a "junk", or high risk stock rally. But this has gradually evolved along familiar lines, and stocks with these characteristics underperformed during the 3rd quarter. While sector weights were important, this rotation toward quality was the driving factor in value stocks' outperformance.

Per Table 6, the quarter's unambiguous large-cap market winners were to be found in the energy, utilities, and materials sectors. This was fed by the general expectation that rapidly rising commodity feedstock prices (crude oil, natural gas, coal, coal, iron, etc.) amid inelastic demand will allow for expanded margins. Winning industries included integrated petroleum, steel, mining, and power utilities. The quarter's other major winners were an electic lot - REITS, homebuilders, restaurant chains, and telecom utilities.

Table 6. U.S. Equities – Selected Sector Performance

(Vestek; cap-weighted data)	Large Cap		Small Cap	
Sector	**3Q04**	**Y-t-d**	**3Q04**	**Y-t-d**
Energy	11.0%	25.6%	12.6%	42.9%
Utilities	6.7	10.8	0.1	6.1
Telecom Services	6.6	10.8	(13.7)	(15.1)
Materials	3.5	4.3	9.4	21.3
Financials	0.4	2.8	4.5	9.3
Industrials	0.0	7.3	(1.3)	8.1
Consumer discretionary	(1.2)	(0.2)	(5.2)	3.4
S&P 500 index	**(1.9)**	**1.5**		
Russell 2000			**(2.9)**	**3.7**
Health Care	(5.4)	(3.4)	(6.5)	2.5
Consumer staples	(5.6)	0.2	(6.4)	5.0
Information technology	(9.9)	(9.7)	(14.2)	(15.5)

The "big three" sectors (financials, health care, and technology) were all weak during the quarter, with computer, communications equipment, and electronic component suppliers especially poor technology investments. The pharmaceutical industry declined over 10%, with nearly half the losses occurring during the quarter's last 10 trading days. Motor vehicle producers, household products, beverage, and retail food chains were all weak industries in the consumer staples sector.

International Markets Rush Ahead

Concerns about global economic growth and future corporate profits prevented most international markets from generating substantial returns for the third quarter, but results were stronger than US equities markets. Developed markets (proxied by the MSCI EAFE index) declined only (0.2)%, and Emerging Markets rebounded strongly with an 8.3% quarterly return. US dollar-based investors were also the modest beneficiaries of the Dollar's weakness versus most developed and primary emerging country currencies.

Table 7. International Equity Markets

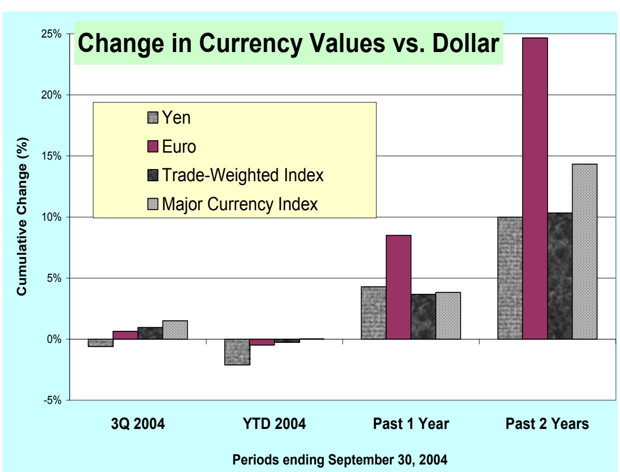
Periods ended 9/30/04; indices are cap-weighted

	3Q 2004 % Return In US$	3Q 2004 Change in Currency	Y-t-d 2004 % Return In US$	2 Years % Return In US$
EAFE	**(0.2)**	**0.8**	**4.6**	**24.5**
- EAFE Growth	(1.6)	-	1.1	19.3
- EAFE Value	1.0	-	8.1	29.8
Europe	1.2	1.1	4.7	27.1
Pacific ex-Jap	9.7	(1.0)	11.1	30.9
Japan	(7.4)	(1.0)	2.5	14.7
Emerging Mkts	**8.3**	**0.3**	**7.4**	**36.0**

Source: Capital Guardian

During the quarter, international growth stocks once again fell short of value stocks, creating a large 7% differential for the year to date. In both developed and emerging markets, similar investment themes drove performance. Rising oil and raw material prices helped the energy and materials sectors surge. The lackluster demand for semiconductors made technology the worst performing sector and consumer-related sectors lost ground due to a combination of weak income growth and high unemployment in many parts of the world.

Chart 4. The Dollar has been Stable in 2004



In the Eurozone, economic growth continues to be driven by exports, as domestic demand remained lethargic. Sectors which performed well included: oil and mining, banking stocks (although selection was key), rebounding wireless operators and pharmaceutical companies.

Problem sectors included insurers and consumer-related stocks. The slowdown in global economic growth negatively impacted Japan's delicate economic recovery and once again raised concerns regarding its sustainability. Concerns about flagging demand drove semiconductor stocks down and this weakness spilled over to other export-related stocks. The ongoing battle amongst three of Japan's largest banks contributed to a decline in financial stocks. Other areas in the Pacific Rim faired much better during the quarter. Hong Kong surged as its economy rebounded and Australia/New Zealand were direct beneficiaries of increased demand for commodity-related stocks.

Table 8. Int'l Equities - Sector Performance

MSCI Sector	Developed Markets 3rd Qtr 2004	Developed Markets YTD 2004	Emerging Markets 3rd Qtr 2004	Emerging Markets YTD 2004
Energy	6.9%	14.9%	17.4%	15.6%
Materials	5.6	6.3	18.8	9.6
Utilities	4.1	14.8	16.1	7.0
Health Care	3.1	5.8	(13.6)	(7.0)
Telecom	1.4	(1.6)	3.8	9.0
Financials	0.6	3.8	8.8	10.4
Industrials	(0.3)	6.9	8.5	10.9
Consumer Disc.	(4.4)	4.4	11.3	5.9
Consumer staples	(6.9)	1.4	9.1	9.7
Information Tech	(9.2)	(5.4)	(4.7)	(3.6)

Data Source: Capital Guardian; Returns in US$

The sharp rebound in Emerging Markets was not uniform across all markets and sectors. Brazil, Indonesia and Turkish markets each rose over 20%. Chinese stocks rose, but at a much slower pace, as concerns over a potentially overheating economy did not abate. The legal travails of Russian oil giant Yukos continues to place a damper on the Russian market and contributed significantly to global oil market turmoil. This is an oil "shock" factor that will ultimately resolve itself (both sides of the dispute want Yukos to export its oil), with timing the only unknown. Cyclical materials and energy sectors posted double-digit gains, while weak performing technology stocks negatively impacted returns, particularly in tech-dependant Taiwan and South Korea. An exception to the worldwide slump in technology stock prices were Indian IT service companies, which posted 20% increases based on expanding volume. Health care stocks were the worst performers in emerging markets, driven by a sharp drop in the value of Israel's largest pharmaceutical company.

Back Page Perspectives

While $55/barrel futures prices for imported crude oil are headline-grabbing, most market forecasters expect trading prices to moderate as we move through the winter. That is because several supply problems are moving toward resolution, including the temporary loss of 25% of our domestic production capability because of hurricane damage. Longer-term contracts have enabled producers to avoid the speculative excesses clearly in the marketplace. Much higher energy feedstock costs ***are*** moving through the consumer products pipeline. Consumer prices for gasoline and fuel oil are virtually guaranteed to rise in the short-term, but then moderate.

Continuing on the inflation issue, of greater strategic concern for investors is evidence the Government's inflation data may be less factual than it should be. It's pretty obvious that major expenditure categories (particularly the housing complex) have been underreported on a systematic basis for some time. The upshot is this – real GDP growth has been slower than reported, productivity has been lower, real wages have been lower, and real interest rates have been lower.

Further, our nation is currently writing checks it may have a hard time cashing. We're simultaneously running three deficits of significant proportions, the combined effect of which is scary. You're familiar with two of them – our record trade/current account deficit and our increasing (but not yet record) fiscal deficit. The third one is our net national savings deficit – which is the shortfall in combined savings by households, businesses, and government compared to that required to fund growth in our productive capacity. With our net national savings rate down at 0.4% of GNP in 2003, and just 1.9% currently, we are more reliant than ever before on foreign funding of our domestic growth.

So what? We've become inveterate overconsumers at the household and government level, are not investing in America, and our dependency on others to do so is burgeoning. This has ominous implications for the Dollar and real interest rates. Remember the late 1980's when we were so concerned about Japan "owning" too much of America, and having undue influence over our capital markets? Triple your concern. And, like any other overleveraged debtor, we're at the mercy of creditors when they decide that our financial assets are no longer attractive at current market prices.

Consequently, we think international investment markets will be crucially important to domestic investors over the next 5 years.

Looking back at Tables 1 and 5, small-cap/large-cap return differentials are stretched. Generally speaking, it does not appear like a good time to re-direct substantial domestic large-cap equity exposure into small/mid caps. The major opportunity may have passed for this cycle, but small/mid-cap valuations are not fundamentally unattractive, and the sector will remain underfollowed as the sell side research industry is reorganized. Long-term investors should not "cash in" their small/mid cap exposure. An actively managed market-weight allocation still appears strategically attractive.

The final twelve months of the prior bear market, the capitulation phase, was so deep that large-cap centered investors (which is to say most institutions) have not recovered from it, despite subsequent returns of 30-45%. With returns from large-caps flat so far this year, it is easy to look back and "write-off" the entire sector. In an indirect sense, that is exactly what's been happening. The S&P 500 index began the year at 1112, with a trailing P/E of 20.5x and the expectation that forward 12-month earnings would rise by approximately 14%. Today, the index is virtually unchanged, and trades at a trailing P/E of just 17.4x. In relative terms, the large-cap sector has declined 15% this year, even though long-term market interest rates are 25 bps *lower* than in early January. We've been is a "stealth" bear market, and domestic equity valuations compared to domestic bonds are becoming strategically compelling.

Just short of two years ago, we wrote, *"keep focus on how you see the future unfolding, rather than re-reading old tea leaves . . . .Issues that investors need to develop a "view" on are –*

- *In terms of pre-conditions, is the domestic economic situation favorable or not? Will the new fiscal and monetary policies help?*
- *Do I want to protect more against the effects of deflation or moderately rising inflation?*
- *Will global politics remain an adverse investment issue over the medium-term?*
- *Do I have confidence that corporate profitability will continue to grow? Is corporate governance on the upswing?"*

We think it's an excellent time for investors to again ask themselves similar questions, as they prepare for 2005-2008.

See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

