Eventually the Traffic Will Clear

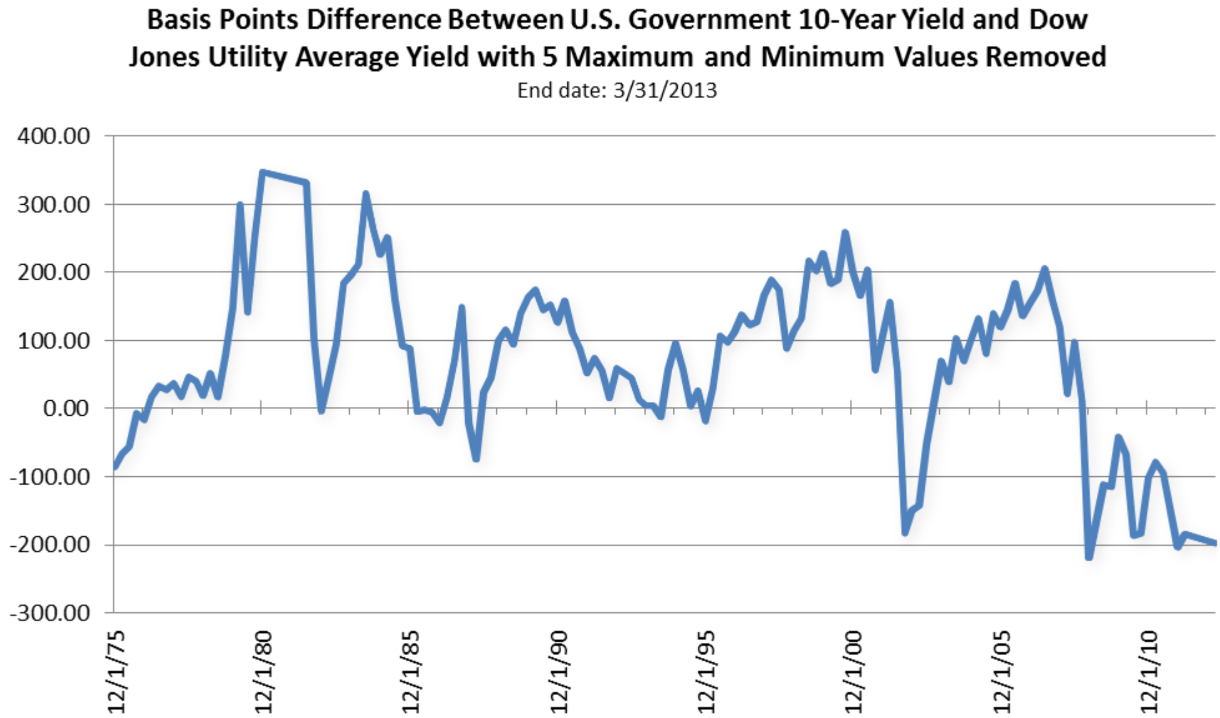
I was both grumpy and frumpy. Having just left a California utility's analyst meeting in Midtown, New York City, I was attempting to drive a bit cross-town to the highway, to the bridge, to New Jersey. It was one of those horrible weather afternoons of 90 / 90 (temperature and humidity); with extra-heavy traffic meaning that going even 10 feet at a time cross-town was an achievement. Those days happen and I know it; but while I'm going through the experience, the "I've been here before" mantra provides little solace. I even remind myself that once past the bridge, the ride will become pleasant, but this is harder to internalize while I am enduring the heat and fumes of the late afternoon. For the moment, I've completely forgotten the quite positive description of the California utility which I had just discussed at length.

Now, a few days later, I feel as though I am reliving my midtown traffic experience all over again, this time via utility stocks rather than by auto. Relentless speculation about rising interest rates and the attendant degradation of the outlook for utility equities are mostly to blame. One can hardly argue against some profit-taking in utilities as a group after their ascent of the past six months. In the stock market, it is inevitable that an interest rate rise will also trigger selling in yield-related stocks, including utilities. In our high-frequency computer-driven trading environment of the past few years, an abrupt downdraft or two also seems inevitable. Nonetheless, much of the bearish market chatter centers around some form of asset allocation strategy away from utilities and/or bigger-dividend type equities and toward those equities which benefit directly from a growing economy, without being harmed by higher rates. As I watch the indiscriminate punishment being handed out to utility stocks, I am seemingly reliving my emotional experience akin to gridlock on a stifling day. In fact, a lot of damage has been done to the stocks of both good and not-so-good companies.

Without getting in to the investment merits of any one company, the analyst meeting I attended highlighted several positive developments which may portend favorably to the utility business. The often-maligned California regulatory agency recently approved a company's filing for higher rates which will pave the way for renewed capital spending over the next few years which should benefit both customers and shareholders. We believe there are other companies, in different jurisdictions, which combine our assessment of a positive regulatory environment, clear growth opportunities, and whose equities offer an attractive and growing dividend. In fact, a collection of what we believe to be excellent examples of those equities with such positive characteristics, adjusted for individual risk considerations, are reflected in our managed portfolios.

During this indeterminate period when utilities are perceived unfavorably, we continue driving our portfolio based upon fundamental analysis, as we have for decades. It seems like a regular yearly occurrence that an interest rate scare will affect the group. We continue to believe that the total-return potential of our portfolios remains compelling. We often use past episodes, such as the period we may be in currently, to continue to upgrade our portfolio for quality and yield. The luxury of a managing a portfolio with continuing positive cash flow (dividends) also allows us a favorable reinvestment horizon. Our experience tells us to look forward, positively, to the time that our investment ride will again be smoother.

Our last observation in this regard is a simple graph.



Average Spread: 72.74 Source: Bloomberg
Data Points Recorded: 140

We compare, quarterly, the difference between 10-year U.S. Government bond yields and the yield of the Dow Jones Utility Average, for the last 36 ½ years. Taking out the upper and lower extremes (10 data points) results in an historical precedent whereby utilities, as measured by the average, regularly yield less than 100 basis points in excess of the 10-year Treasury bond. At the current level of about 2.2% yield on the 10-year and 4.0% on the DJUA, we remain sanguine on the index's implied message for utility stock valuation. Based upon our actual portfolios, we are confident in providing a favorable return to our clients.

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