RIKOON CARRET
510 Don Gaspar
Santa Fe, NM 87505-2626

Telephone: (505) 989-3581
Fax: (505) 983-8086

Commentary
Summer 2004

Market Performance

The second quarter of 2004 was a roller coaster ride, beginning with a steep plunge and ending where it started, flat for the quarter and also for the first six months of the year. Investors are pulled in opposite directions, between feeling encouraged and optimistic about corporate earnings and the economy but pessimistic about the world at large.

With Iraq, terrorism, and the coming election constantly in the forefront of the day's news, it is hard for people to feel positive about macro issues, but most consumers are out spending so business production continues to increase with a resultant expanding economy.

Inflation is another big worry. The Federal Reserve raised interest rates, for the first time in four years, from a 45-year low level of 1 % up to 1.25 %. Most professionals expect the Fed to continue boosting rates, perhaps going up to 2 % by the end of the year.

With the Fed broadcasting their future plans to the markets, this last move up in interest rates was not a big event. During the April to June 2004 period, interest rates in the bond market rose almost a full percentage point over where they were on March 31, so bond markets were down.

During the first six months of 2004, the Standard and Poors Index of the 500 largest U.S. companies gained 2.6 percent. In comparison, the Rikoon Carret U.S. stock portfolio gained 3.44 percent. Our international stock portfolios gained 2.94 percent compared with the Dow Jones Euro Fifty Index gain of 1.83 percent.

The bond market index had a rough start to the year, with the tax free index down .26 percent and the taxable bond index down .72 percent. The Rikoon Carret portfolios gained .28 percent in the tax free area and .2 percent in the taxable area, so we continue to outperform the markets.

Now that the Federal Reserve has started raising interest rates, investors' best hopes for the stock market's future gains hinges on increasing company earnings. We feel that in the short run, three to six months, the profit news will be positive, but beyond that date, the stock market needs a perfect report card to make ongoing gains.

Inflation has reared its head with increased labor and materials costs nation wide. This eventually will erode profit margins and make earnings comparisons more difficult. The price of oil is key to our economy. A substantial drop in oil prices would mean that the Fed would not have to raise rates and that would support further gains. On the other hand, any political upheaval in the Mideast or U.S. would send investors to the sidelines.

We believe that company earnings will start to decelerate as the Fed raises rates. It is important to look back at history and note that this may be a good time to take money out of the market. Over the last 18 months, the stock rally has followed a typical pattern and it has been helped by the Fed's reluctance to raise interest rates even in the face of rising oil prices. Going forward, we do not expect to see the same kind of stimulus that has thus far helped the stock market to go up in late 2003.

Real Estate as an Alternative Investment: Pros and Cons

Real estate represents a good form of diversification away from traditional stock and bond markets. As with all forms of investment, it is important to know about the different ways of putting your money to work and be cognizant of the relative advantages and drawbacks of each avenue. People often believe that real estate values always go up, especially over any short time period, such as 1-3 years. I do not agree.

Real estate investors must have patience and the ability to hold the investment for an indefinite, long period of time. If you are not prepared to hold and have purchased property using debt, you can end up under extreme pressure to get results quickly. The cost of borrowing money gets higher over time and it can depress the investment returns on property.

Demographics does point to rising population and increased demand for housing, but housing is often cheaper to build new than buying older properties. The rate of new construction can therefore keep prices down in saturated markets for sustained periods of time. Desirable locations tend to become more expensive over time and recreational properties fetch high prices. Without proper zoning and environmental protections, however, the character of vacation property can change rapidly, putting investments at risk.

One advantage of raw land is that it requires little maintenance. The truism "Land, they ain't making any more of it" can easily lead to the conclusion that it is without risk. Nothing could be further from the truth.

Investors can be subject to sharply increasing taxes, condemnation (where the government decides it wants to use property for the public good), or bad luck, such as residents near Love Canal, Three Mile Island and farmers near the Hanford Nuclear site discovered.

People who need income from their investments are generally not well served by raw land unless it is leased out. Rental properties, both residential and commercial, are attractive but tricky places to look. Every rental market has positive and negative aspects. The choice to invest directly, on one's own or with other people, is an important decision.

The requirements for ongoing management of rental real estate should not be overlooked. One can contract this service to outside parties but, from a profitability point of view, buying a rental unit and managing it oneself is usually the best way to go.

There are few people who can afford to buy rental units who are willing or able to personally manage it. Real estate management involves interruptions, at any time, to deal with renters, complaints, and maintenance or repairs. Then there are the bookkeeping, monitoring taxes, and insurance issues. Whew, I am getting tired just thinking about all these tasks.

There are alternatives for investors who want and need a steady stream of income and who desire the underlying source of revenue to be real estate. One can buy Real Estate Investment Trusts, or REITs, in a brokerage account. REITs are investment firms who concentrate in a particular type of property, such as apartments, storage units, health care facilities, office parks, shopping malls, prisons, and rehabilitating historic or low income housing.

REITs package several properties together and then are responsible for the management of the properties. Downsides of REITs are high management fees, wide fluctuations in the price of the REIT stock, and the possibility that the REIT has high levels of debt or is making unsustainable payouts to investors. The upside is the income produced by these types of investments.

Limited partnerships (LPs) are available to qualified investors in real estate though they require higher minimum investments. They are fairly illiquid and non-transparent, meaning investors do not control when the properties are sold or at what price. The managing partner or member collects a management fee and shares in the profits. These opportunities are more targeted than the REITs, meaning they can choose one or two locations and the managers are hands-on in selecting tenants, arranging for repairs, etc.

Real estate is a great way to diversify your portfolio, either through appreciation or income. It doesn't necessarily have to be a huge headache but don't go into it with unrealistic expectations. Expect to pay for management services and understand properties' limitations in terms of liquidity, possible cost overruns, and the uncertainties of particular geographic markets. Your final results will depend, as they always do, on buying at the right price and selling at the right time.

Private Equity

As interest rates and inflation rise, alternative investments give investors a chance to capture appreciation or earn income in a completely different way than publicly traded stocks, bonds, and mutual funds. Private equity is so-called because, as opposed to publicly traded securities, they are not sold in auction markets, like the New York stock exchanges, nor can they be traded over computers. They are also subject to far less government scrutiny. It takes time to research opportunities in private investments and, like real estate, the timing of when one can transact changes in private equity holdings is limited, sometimes severely so.

Private equity investments are in private companies, so they are very dependent on local managerial talent and ability. Private equity usually means buying stock in a business that is small. Having private stock means that the circle of co-owners is likely to be small.

People who get it right in private equity can make a lot of money regardless of what the overall stock market is doing at the time. The odds of success for small companies is typically low and though daring successes like Amazon.Com, Krispy Kreme, and Starbucks are highly rewarding to early private investors, the roadside is littered with companies with great ideas that did not make it.

A key player in creation of a successful private equity investment is the professional analyst who sifts through candidate companies and who chooses a variety of private company stock investments to combine into a “fund.” Funds are supposed to take responsibility for everything on behalf of the individual investor. There is a renewed interest in local business ownership which has led some fund innovators to try to create private community minded vehicles.

There are several negative attributes to private equity which include, but are not limited to, high risk, low liquidity, lack of transparency, loose regulation, and reliance on a few key managers. Commensurate with the risk is the fact that investors do have a chance to make very large returns. A positive result of funds that target specific management style, industry, region, or stage of business is that investors can have a greater degree of certainty that their personal brand of ethical screening will be applied than exists with publicly traded companies. For example, early investors in Ben & Jerry’s could see the benefit of their stock investment on the lives of organic dairy farmers in Vermont.

Private equity funds, like some real estate investments, are typically available only to wealthy individuals. They often come with high minimum investments of $100K, $250K or even $1 million. Due to Wall Street’s excitement that investors with smaller amounts would be attracted to these venues, a new breed of private equity closed end fund has arrived on public stock exchanges. They look and trade like traditional stocks.

Several firms in New York hope that there are enough individual investors who have smaller amounts to invest: two, ten, or twenty-five thousand dollars, which so invested will allow the investment firms to reap large fees. This is because the funds are allowed to borrow money, using the individual investors' money as collateral, and then they can charge fees on the investor funds plus the borrowed funds!

My question for these public funds is whether the smaller investors will get the same quality of deals as the big players, not just the second- or third-rate deals. Mutual private equity funds' prospectuses state that there is no guarantee that investors in the public fund will be participating in the same investment opportunities as the investment house's larger clients.

The frustrations investors feel in the stock and bond market can have a productive outlet through private equity, but, as is true for most investment propositions, proper execution is the key. There is no substitute for doing your homework! In upcoming commentaries, I will be describing investing challenges and opportunities in private equity, especially those in New Mexico, as well as other alternative investment vehicles.

Personnel News and Other Events

All of us here at Rikoon Carret have settled in to our new organizational structure as, in May, we formally re-established ourselves as a separate company from our partners in New York. We have been meeting regularly on the weekends to develop our long-term strategic plan and, as a result, several new offerings are in the making. Trust services, bookkeeping, insurance, tax and estate planning consulting will soon be added to our roster of formal activities. Stay tuned.

Rob recently competed in his first "adventure race" which involves trail running, mountain biking, white and flat water paddling, with orienteering throughout. This means there are no signs telling contestants which way to go. There was also a smattering of rock climbing and rope work thrown in for good measure! Adventure racing is a 3-person team sport where the team must stay together. If any of our readers are interested in 8 to 48 hours of outdoor fun, please let Rob know.

Jeff would like to thank those of you who were able to attend the long-term care seminar that we held in June. Bob Huey, the presenter was informative, objective, and made the subject very interesting. A number of clients called to say that they would have liked to have attended but were not available during the summer. We have, therefore, invited Bob to return to our office on Thursday, October 16 at 3 p.m. to discuss long-term care options.

Dan has been studying for his Investment Advisor exam while helping out in the background with paperwork and office management. He's looking forward to finishing his studies and contributing to the analysis and advisory work of the firm. On the weekends, Dan and Rob have been joining an organized group for early morning mountain biking in the forests surrounding Santa Fe. And on the family front Dan's daughter Nathalie turned 6 months old in June and has started rolling over, much to the delight (and slight apprehension) of her parents.

Patricia took a trip to Orlando over Memorial Day to meet our Schwab Operations team. She met with them for two days and then took a lovely side trip to St. Augustine on the coast. Also she is involved in forming an email network involved in connecting groups of people from the United States to other parts of the world just to open dialog. This network is called Peace x Peace. Please call her if you would like to know more.

Seminars and Client Presentations

Our clientee schedule for the upcoming months is as follows: our next afternoon “tea” gatherings will be held on the second Thursdays of September and of November from 3-5 p.m. Mark your calendars for September 9 and November 11. We look forward to having you join our discussions.