

Krosnowski & Scott LLC

Investment & Retirement Planning Specialists

Financial Fitness Newsletter – Fall 2004

Corporate Definition

First Allied Securities, Inc. is A Non-Bank Affiliate of Wells Fargo & Company (WFC). Krosnowski & Scott, LLC is the local First Allied Securities, Inc. office. Wells Fargo Investments, LLC (WFI) is the clearing agent for all client accounts. One of the main reasons we left Morgan Stanley over 5 years ago was because we felt the major Wall Street Firms put their needs ahead of those of the client. Our aim at Krosnowski & Scott, LLC is to put the needs of the customer first. To accomplish this goal we recommend comprehensive financial solutions to our clients that emphasize the use of independent products and services. Our corporate focus at Krosnowski & Scott, LLC is to build enjoyable long term relationships that are built on a foundation of trust.

Financial Market Outlook

On August 14th, we attended a money management conference hosted by Wellington Asset Management in Boston. Wellington manages over \$400 Billion in assets for institutional and individual investors. They manage assets for the Hartford and Vanguard funds. At the conference, we found the presentation of Dr. Quincy Krosby, Wellington's Chief Investment Economist to be very informative. A PHD in economics and a former US Ambassador for the US State Dept., she has in- depth knowledge of the global energy markets. The following are a few of Dr. Krosby's viewpoints regarding the financial markets.

- Due to geo-political uncertainties in Venezuela, Iraq, and Russia, crude oil future prices are trading based on a fear premium. The financial markets are assuming that there will be disruption in the distribution of energy supplied by these producing countries. As a result, oil prices are trading in the high forties to low fifties per barrel. Oil prices are expected to stabilize at a lower price level, hopefully in the \$35 to \$40 range. Surprisingly, due to the outsourcing of the production of goods and services to countries with lower labor costs such as India and China, inflation has been held in check even in light of dramatically higher energy and commodities prices.
- Even though Saudi Arabia offers to increase crude oil production to meet rising demand there is no way to quantify if they are actually increasing output or if it is just lip service to calm the energy markets. There is a concern, since they have not been reinvesting in their energy production facilities, as to whether they are capable of increasing their energy production.
- In the 1970's the US imported 1/3 of its energy consumed. Today the US imports 60%, with the major suppliers being Canada (17%), Mexico (13%), Venezuela (12.8%) and Saudi Arabia (11.7%). Transportation accounts for 60% of the energy consumed in the US. We must improve our situation by instituting policies that encourage energy conservation (emphasize more fuel efficient automobiles), increase domestic energy production and the further development of alternative fuel sources (fuel cells, solar and wind). Reducing our reliance on petroleum energy imports from foreign countries (especially the ever turbulent Middle East) will stabilize both energy prices and the financial markets.

- US Large Company stocks are undervalued. Based on the 12 month forward P/E ratios using 2005 S & P 500 earnings estimates. Currently the S & P 500 is trading at a forward P/E ratio of approximately 15.5 based on 2004 earnings estimates.

As we discussed in our last newsletter, the performance of Large Cap (Quality-blue chip) companies has been lagging Small Cap (more speculative) companies over the past four years. Over a recent three year period, Small Cap stocks nearly returned 75% while Large Cap stocks returned around 5%. There is data that indicates that the trend of small cap out performance is beginning to reverse itself. Based on your investment objectives and comfort level we feel it is advisable to own both classes of stocks to encourage diversification to manage risk and provide for more consistent returns. Normally, when interest rates are rising, it creates an environment that is more beneficial to larger companies than smaller companies because it is easier and less costly for larger companies to finance their operations (i.e. it is easier for larger companies to borrow money than smaller companies.)

- On a separate note, we feel real estate prices are currently over valued and are due for a correction. As a result, we recommend avoiding additional real estate investment until prices pull back to more reasonable levels.

Correlation of Investment Returns of Asset Classes

The concept of diversifying your assets into different classes (similar to not having all your eggs in one basket) is based on the premise that the price movements of these various asset classes are not directly correlated. As a result, spreading your assets across different asset classes will enable you to reduce price volatility (risk) versus investing in one asset class. The following tables illustrate the correlation of returns of different asset classes:

Chart A - Correlation of Growth and Value Stocks

This chart illustrates that a portfolio which combines Large-Cap Growth and Small Cap Value stocks has a correlation of .50. This means that 50% of the time these two asset classes move in the same direction and 50% of the time they move independently of each other. As a result, investing in these two asset classes offers investors higher diversification benefits than investing in asset classes that have a correlation of greater than .50.

Growth and Value Series

Serial and Cross Correlations of Historical Annual Returns from 1969 to 2003.

Series	IA All Growth Stocks	IA All Value Stocks	IA Large-cap Growth Stocks	IA Large-cap Value Stocks	IA Mid-cap Growth Stocks	IA Mid-cap Value Stocks	IA Small-cap Growth Stocks	IA Small-cap Value Stocks
IA All Growth Stocks	1.00							
IA All Value Stocks	0.82	1.00						
IA Large-cap Growth Stocks	0.99	0.77	1.00					
IA Large-cap Value Stocks	0.84	0.99	0.81	1.00				
IA Mid-cap Growth Stocks	0.89	0.84	0.81	0.83	1.00			
IA Mid-cap Value Stocks	0.63	0.91	0.55	0.85	0.76	1.00		
IA Small-cap Growth Stocks	0.80	0.83	0.70	0.79	0.96	0.81	1.00	
IA Small-cap Value Stocks	0.59	0.87	0.50	0.80	0.77	0.97	0.85	1.00
Serial Correlations	0.07	-0.01	0.14	0.01	-0.06	-0.07	-0.03	0.03

The standard error for all estimates is 0.12



Chart B - Correlation of Stocks, Bonds, and Inflation

Basic Series and International Stocks.

Serial and Cross-Correlations of Historical Annual Returns from 1970 to 2003

Series	International Stocks	Large Company Stocks	Small Company Stocks	Long-Term Corp Bonds	Long-Term Govt Bonds	Intermediate Govt Bonds	U.S. Treasury Bills	Inflation
International Stocks	1.00							
Large Company Stocks	0.59	1.00						
Small Company Stocks	0.42	0.68	1.00					
Long-Term Corp Bonds	0.09	0.33	0.12	1.00				
Long-Term Govt Bonds	0.08	0.27	0.04	0.95	1.00			
Intermediate Govt Bonds	-0.04	0.19	-0.02	0.93	0.93	1.00		
Treasury Bills	-0.11	0.03	-0.04	-0.02	0.02	0.25	1.00	
Inflation	-0.20	-0.23	-0.03	-0.45	-0.39	-0.23	0.63	1.00
Serial Correlations	0.15	0.06	0.07	-0.11	-0.26	-0.14	0.79	0.73

Note: Underlying data expressed in U.S. dollars.

Chart C - Correlation of Equity REIT's with other Financial Sectors

The correlation coefficient which ranges from -1.0 to 1.0, describes the strength of the relationship between two sets of numbers. A positive correlation coefficient indicates that one set of numbers tends to increase as the other increases. A correlation coefficient of zero means that two sets of numbers are completely unrelated, while a negative correlation coefficient indicates that the numbers tend to move in opposite directions.

Correlation of Equity REIT Returns with Other Investment Sectors

MARKET SECTOR INDEX	30 YEARS 12/31/73 – 12/31/03	20 YEARS 12/31/83 – 12/31/03	10 YEARS 12/31/93 – 12/31/03
Small Stocks	0.77	0.70	0.37
S&P 500 [®]	0.54	0.45	0.29
NASDAQ Composite ¹	0.49	0.38	0.16
Dow Jones Utilities	0.45	0.39	0.39
Long-Term Govt Bonds	0.21	0.30	-0.03

(Correlation coefficients)

based on monthly total returns, except where noted)

Sources: Ibbotson Presentation Materials, ©2004 Ibbotson Associates, Inc. All rights reserved. Used with permission. REITS_NAREIT Equity Index; Small Stocks – Ibbotson U.S. Small Stock Series; Bonds – 20 year U.S. Government Bond; NASDAQ Composite – NASDAQ.

Data series drawn directly from actual index values. ¹ Price appreciation only.

PLEASE SEE ATTACHED DISCLOSURE

DIVIDENDS - “CAN’T GET ENOUGH!”

According to Jeremy J. Siegel, PhD, professor of finance at the University of Pennsylvania Wharton School of Business, “Dividends keep companies and the market honest. While companies can be creative in manipulating the numbers to make earnings look good, they can’t create the cash necessary to pay out a dividend unless the earnings are really there to begin with.”

Did you know that from 1968 to 1977 the DJIA remained flat and that dividends represented 80% of stock investor’s returns over that period of time? During the decades of the 1980s & 1990s average annual returns were *17.5% and 18.2% respectively. These returns were way above the 77 year Large Stock average annual return of 10.4%. As we move back toward the mean (historical average) return there is a good chance that the current decade will be similar to the flat stock market we experienced in the 1960’s and 1970s where the average annual returns were *7.8% and 5.9% respectively.



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As we adapt to this market environment we would be wise to seek out investments that not only have a history of consistently paying dividends, but that also have a track record of increasing or growing their dividends. Please contact us for a list of companies and funds that focus on a dividend oriented investment approach. We have some excellent research from Morningstar and Value Line to share with you. The new dividend tax law also makes dividend paying investments attractive. Under the Jobs and Growth Tax Relief Reconciliation Act congress lowered the dividend tax rate to 15%.

* Performance data source: Ibbotson Associates, PLEASE SEE ATTACHED DISCLOSURE

IRA Distribution Facts

- **Asset Allocation**- Over the long run stock allocations of less than 50% have historically led to lower success (i.e. over weighting bonds increases your potential to deplete your assets over the long term).
- **Excess Withdrawal Risk**- Based on a balanced portfolio (50% stocks/40% bonds/10% short term investments) the greater your withdrawal rate the more quickly you will diminish your assets. The exhibit below illustrates various withdrawal rates:

<u>Withdrawal Rate</u>	<u># of years portfolio will last</u>
9%	13 Years
7%	18 Years
5%	27 Years

Source: Fidelity Investments, PLEASE SEE ATTACHED DISCLOSURE

NUTRITION UPDATE

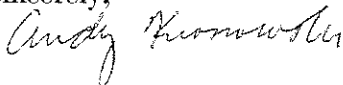
Walnuts - "The Next Best Thing to the Fountain of Youth"

- Did you know the FDA permits the walnut industry to advertise this claim: "Supportive but not conclusive research shows that eating 1.5 ounces per day of walnuts as part of a diet low in saturated fat and cholesterol may reduce the risk of heart disease."
- Walnuts are unique in that they are a powerhouse of nutrients, and they contain omega- 3 fatty acids, fiber, plant protein, as well as a lot of bioactive compounds including vitamin E," said Penny Kris- Etherton, Ph. D., distinguished professor of nutrition at Pennsylvania State University.
- Walnuts not only help reduce cholesterol, but also contain a number of other important vitamins, minerals, proteins, and antioxidants. A study from the University of Minnesota and University of Oslo reported that walnuts contained the second highest concentrations of antioxidants among the numerous foods tested, which included fruits, berries, vegetables, cereals, and nuts.
- **Promote Weight Loss** - Additional studies have shown that walnuts may also make it easier to manage your weight. In a study published in October 2001 in the *International Journal of Obesity*, study participants who included peanuts and tree nuts, such as walnuts, in their diet were able to improve weight loss and keeps weight off for a longer period than people following a traditional recommended low-fat diet.

*Source: Washington Senior Beacon September 2004

We hope you had a nice summer and that you enjoy the enclosed article reprint from the Washington Business Journal. We look forward to talking and meeting with you in the future.

Sincerely,



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