



Third Quarter 2004 Analysis

The market moved sideways during the quarter with a slight downtrend. The unusually high crude oil prices were probably the most significant deflator in the economy. While many individuals may think the high prices are due to OPEC's failure to pump more oil, the actual causes go beyond OPEC's actions. We have found the rise in prices due to the follow factors:

- Rising demand: As more countries modernize, their demand competes with America's needs. The International Energy Agency reports that the demand for oil is at a 24 year high. China's demand alone is up 20% over last year. Among suppliers, only Saudi Arabia has capacity to increase output.
- Low Reserves: Oil companies have tried to become more efficient in recent years by maintaining lower inventories. There is less of a cushion in the market against supply disruptions (e.g. terrorist sabotage, strikes in Nigeria and Venezuela, etc.)
- OPEC Strategy: The oil cartel has been aggressive in monitoring global supply and proactively adjusting output. In the past, the cartel waited until prices dipped before reducing supply. Additionally, the spring and autumn caused oil surpluses due to weaker demand and oil companies used this time to rebuild their stocks. The current OPEC strategy appears to have closed these windows.
- Speculators: The combination of low inventories and Opec's action to keep them low leaves the market vulnerable to sudden price spikes. This has not gone unnoticed by professional market speculators. Their betting on the prices going higher has exacerbated the situation. Oil ministers may blame the speculators, but the speculators only reacted to Opec's strategy. The current market situation cannot be easily reversed simply by pumping more oil because most producers are pumping at capacity.
- Political tensions: Violence in the Middle East is hampering the reliability of Iraq's production. If the violence would extend to Saudi Arabia, it would be a major event.
- Insufficient US refinery capacity: Finally, we are part of the blame. While environmental regulations have increased from state to state requiring numerous blends of gasoline, building processing plants to handle this increased regulation and growing demand has been hampered by the same environmental concerns and permission to build is difficult to obtain.

The bright side of this analysis is that we are still well below the crisis level experienced in the '70s. We are confident that the markets will adjust and alternatives will mitigate the current situation. Hopefully this situation will provide an impetus for allowing drilling in ANWR and reducing our reliance on foreign oil.

While the stock market struggled, the bond market also hit a few bumps as the Federal Reserve began to raise interest rates. The only sector that seemed to perform well was the REIT market. We decided to stay mainly in cash and hold our current positions.



Our Holdings & 3rd Quarter Activity

During the quarter, the few stocks that had any significant gains were from companies with questionable financial footing that had been high performers in past periods. This type of stock appears to be a “value” to some investors. However, at Trustar, we call this type of investing “bottom-fishing”. Yes, you can find some occasional stocks that will move up from the bottom resulting in statistical out-performance (e.g. a stock moving from \$1 to \$2 results in a 100% gain). The problem with bottom-fishing is that you engage in a very high risk/reward practice and the track record of bottom-fishers is a bit muddy. As much as we want to be in the market and making gains, three out of four stocks are going to follow the trend and we don’t think the rewards are sufficient if there is a 75% risk that our purchases will go south.

Near the end of the quarter, we began to see some very positive stock patterns develop in the companies we were following. In the final week of September we finally saw the first companies successfully breaking out of their bases and move to higher ground. Most significantly, we saw a healthy increase in the markets’ volume. This indicates that institutional investors are leaving the sidelines and getting back into the markets. Some of those stocks taking off were Cognizant Technologies, DOW Chemical, Level 3 Communications, and Sierra Health to name a few. We were watching them before their breakout and closely tracked their performance during their breakout.

Conerstone Realty (TCR): As mentioned earlier, the reit market appeared to do the best of all the sectors. We saw TCR go from \$8.80 at the end of June to break through the \$10.00 barrier and reach a 52 week high. Even when TCR suffered last year and many thought their dividend would be reduced, we stayed the course and have now been proven correct. The trading volume increase in TCR denotes that many investors think the worst for TCR is behind them. All along TCR continued to provide an excellent yield at \$.80 per share.

Thoratec (THOR), Ameritrade (AMTD) and Nortel (NT): This fourth quarter should reveal if we were correct in holding these stocks.

Thoratec received a significant increase in reimbursement from Medicare on its heart devices. They have a monopoly on the market and we’ll see if they are able to capitalize on these favorable conditions. As we mentioned last quarter, the management has very little credibility with investors and this stock probably won’t move very much until they report their 3rd quarter results on October 21.

Ameritrade is still recovering from the slow summer trading season. Their 50-day moving average has turned positive and we anticipate the trend to continue.

Nortel is supposed to announce their revised audited results at the end of October. The whole market is waiting for this event and it will either confirm our earlier prediction that Nortel’s intrinsic value is sound or we will be proven wrong. Based on our research and the bi-weekly updates from Nortel, we are very optimistic on this stock.



Serological Corporation (SERO): Sero was purchased when it broke out of a cup and handle base on high volume in March (1). The market began to correct and SERO traded sideways for the next five months while forming a new cup and handle pattern. It again broke out of this pattern in September (2) and has run up over 20% from our initial purchase. We think there is still plenty of room for SERO to grow as they continue to acquire patents and FDA approval for their vaccines.



We also made a purchase a few days ago in Yahoo (YHOO). We watched them breakout of a normal cup and handle pattern and purchased them at \$34.65. They had very good fundamentals and the overall market is currently in a rally.





Sometimes patterns do not always hold up and that is why we do not “jump-the-gun” and buy a company just because a pattern seems to be evolving. Even if a company has solid financials, the timing is crucial. The graph below shows that Dr Horton, Inc. (DHI), a company we were following, was forming a nice pattern. But as you can see, the handle fell apart and instead of a high volume breakout, the stock took a severe plunge (1). Therefore jumping-the-gun and trying to get into a stock too early can many times burn an investor.



Fourth Quarter Outlook

In addition to our recent purchase of Yahoo, there are many stocks forming nice patterns and the market is currently in a rally. It seems strange that the market is rallying while oil prices continue to hit new highs. However, we don't try to predict the market too much but instead try to react quickly to its changing dynamics. We mentioned in our last quarterly commentary that we planned to make a large purchase in ACG for our fixed income clients. However, the conditions failed to improve and we stayed in cash. We still strongly desire to be in ACG and to benefit from their high dividends.

Other Business

We appreciate all of your referrals to us. In order to encourage even more referrals to us, we will wave your next quarterly fee if you refer a new client to us. Also, past quarterly commentaries are available on our website as well as our current ADV report on file with the Ohio Securities Commission.



If you have any questions about this analysis, please do not hesitate to call me. Thank you for your continued patronage.

Sincerely,

A handwritten signature in blue ink, appearing to read "Jonathan Davey", is written over a horizontal line.

Jonathan Davey, CPA MBA
Registered Investment Advisor