

Sound Investments Inc.

Kenneth A Gilpin CFP

Third Quarter 2004

September was a good month for both the markets and our portfolios.

Macro-economic and geopolitical developments are extremely difficult to confidently and accurately assess. So they are not primary drivers of our asset-allocation strategy. However, we don't ignore them. Rationality also requires us to assess what could happen and how different scenarios would impact our portfolios.

The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

Quarterly Investment Commentary—Why We Are Rationalists

September was a solid month for equity markets and, generally, a very strong month for our active managers. Small-cap stocks, foreign stocks, and growth stocks were particularly strong. For the full quarter, however, equity markets were under water. Concerns about oil prices, geopolitics, the election, employment, and earnings all contributed to equities' weakness while fueling a bond rally. Our Mutual Funds did well again the major indexes.

The first three quarters saw swings back and forth within a wide trading range, repeating four upswings and four reversals. An enduring leadership change has yet to materialize. Thus far, small cap leadership remains intact. For the last five years ending Sept 30th 2004 the Russell 2000 small cap index has an annualized gain of 6.1% while the Russell 1000 large cap index has a yearly gain of 2.2%. Value stocks have also been on a five year roll, gaining an annualized 7.4% since 1999 vs. a loss of 3.5% for growth stocks.

Small company funds out performed large company funds so far this year and as typical, have been more volatile. During this years declines small caps were far weaker than large caps. Anticipating a leadership change to large caps some were quick to call an end to the five small cap trend. However, each time stocks rebounded, small caps gained far more than large caps

Small outperformed large in both the value and growth camps again last month. We believe it's far more effective to follow market leadership than to forecast it.

Value investment styles continue to outperform growth funds in all size categories last month reflecting investor's reduced appetite for risk. In times of uncertainty investors seek stability hence these funds have done better.

I could write a four page letter listing all the pros and cons of what to do next. However what I try to do is stay with the trend which favors international value funds, small cap and this month we're adding Price New Era Fund which invest in natural resources (i.e. oil and gas). The Pimco Total Return Bond Fund has done well lately too.

Earnings Surge Forward

Due to the added strength of the economy, earnings moved forward during the third quarter. For the year to date earnings are up about 20%. In the 3rd quarter out of 500 hundred companies earnings were higher for 375 of them while 72 were lower and earnings growth for the rest were neutral. More interesting earnings have tended to exceed Wall Street forecast. If growth can continue in 2005 it could create some surprises on the upside.

Waiting for the Right Pitch

With end of 2004 in sight we continue to have only lukewarm enthusiasm towards the available investment options. So, like Barry Bonds, we must stay disciplined and refrain from swinging at pitches not to our liking. Or, to put it another way, in the words of the great investor, Warren Buffett, "the stock market is a no-called strike game. You don't have to swing at a questionable strike – you can wait for your pitch."

We Are Why Rationalists

For optimists and pessimists, their views can influence what they see. For rationalists, what they see determines their views. Our job is to weigh the arguments put forth by both optimists and pessimists and to assess them rationally and without bias.

We are paid to be rationalists. Rationality requires us to recognize what we can confidently assess and what we can't. Here's what we believe

- equity-type asset classes are generally in a fair-value range. That suggests that a normal level of risk is reflected in stock prices.
- For the most part bonds look a bit pricey. Investment-grade bonds are priced at very low yields. For example, the 10-year Treasury yield is about 4% as we write this. Compared to inflation, yields are below their long-term average and this suggests that investors are somewhat pessimistic about the economy. Looking out over the next few years it wouldn't be surprising to see interest rates drift higher, resulting in low single-digit returns for bonds. (Indeed, modestly higher rates would be welcome because they would go hand-in-hand with a healthy recovery.)
- Looking overseas, many countries don't have the structural imbalances the U.S. has (huge trade deficit, low savings rate, and high debt levels). And based on most metrics, foreign stocks look undervalued relative to U.S. stocks. We have less confidence in the quality of the data available on foreign stock-market valuations. For these reasons we have a more demanding valuation standard.

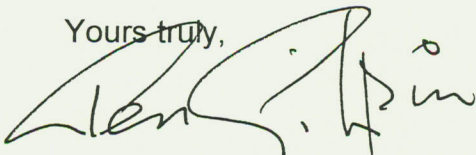
Conclusion

There are a lot of factors to consider and it's hard to accurately assess but we believe a supportive inflation/interest-rate environment and continued gradual growth is the most likely outcome. Our view is influenced by healthy levels of

cash on corporate balance sheets, muted inflation, and consumer spending that remains solid though there has been some slowing. However we remain neutral neither overly aggressive nor ultra-conservative. And while it's frustrating to stand in at the plate with the bat on our shoulder, the one thing we can say with certainty is that opportunities will come. The world will always be a volatile place and at some point something will cause investors to act irrationally. So we must be willing to be patient for however long it takes.

As always, we thank you for your confidence.

Yours truly,

A handwritten signature in black ink, appearing to read "Ken Gilpin", written over a horizontal line.

Ken Gilpin CFP