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ValueWorks:

Redefining wealth management through critical thinking and independent research

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An Eye on the Fundamentals ...

We continued to make steady progress through the first half of the year. For the period the Dow advanced 0.8%, the S&P 500 added 3.3%, and the Nasdaq added 2.4%. Over the first half of 2004 our Capital Appreciation Composite rose by 6.6%, inclusive of a 2.4% gain in the second quarter.*

On the economic front, there is ample evidence the economy is expanding. True to age-old precepts, fiscal and monetary stimuli have slowly found their way through the system and have re-ignited economic growth. As this has become increasingly evident, the markets have stalled, focusing on the near-term impact of higher interest rates. This market pause makes sense to me in the context of the massive advance we experienced from the recent lows of March 2003, coupled with the challenges inherent in unwinding the stimulus that is in place. However, after six months of stagnation and retrenchment, I believe the near-term outlook for the broad equity indexes is more positive than it has been since year-end.

While there is plenty of white noise to cloud the picture, I believe the underlying reality is that we are in the early stages of a classic business cycle expansion. The evidence of economic growth can be seen in everything from railcar loadings to corporate profits to hours worked. After an extended period of historically low interest rates and government deficits of close to 5% of GDP, it makes perfect sense from the perspective of traditional economic theory that this would be taking place. Also within this context, higher interest rates are clearly appropriate, bearing in mind that a Fed Funds target of 2-2.5% would still be accommodative and continue to fuel economic expansion.

I have long held the view that inflation and interest rates were in a long period of decline, and the threat of higher inflation was not credible. I consider that period of long-term decline to be behind us. Currently, the prospect of higher rates is quite likely, and the risk of accelerating inflation is no longer a concern to dismiss out of hand. To the contrary, there is ample evidence that price acceleration has occurred over the past year. I therefore consider higher Fed Fund rate targets to be healthy and appropriate, and in the less-immediate term, an overall positive for the economy and the markets.

ValueWorks' Top 10 holdings*:

1. **Apple Computer**
2. **Freddie Mac**
3. **Calpine Cap Tr III pfd**
4. **Wachovia Corp**
5. **Sony Corp. ADR**
6. **Sun Microsystems Inc.**
7. **Pfizer Inc.**
8. **Baxter International**
9. **Walt Disney Co.**
10. **Rowan Companies Inc.**

—as of 06/30/04—

*see notes on p4 for additional information

*ValueWorks figures are gross of fees. For additional information on returns, including net performance, see page 4.

That said, there is a quirky element to the inflationary pattern we are seeing, the implications of which suggest inflation is less likely to become entrenched. Inflation is rising at the beginning stages of an economic expansion, and reached its lowest level at the end of the last economic expansion. A case can be made that inflation was lower at the end of the last economic expansion than it was at the beginning of that expansion, and was higher at the end of the slowdown than at the beginning of the slowdown. That is contrary to classic assumptions about inflation through the business cycle. Classically, inflation is expected to be low in the early stages of an expansion, gradually building as excess capacity becomes absorbed. The ratcheting up of interest rates at the end of the cycle is designed to slow growth and wring inflation out of the system.

This reversal in the timing of inflation's acceleration is consistent with inflation being driven more by restrained access to capital than by higher final demand. The contraction in the credit cycle hit producers much harder

fig 1. Asset Class Diversification (Capital Appreciation)

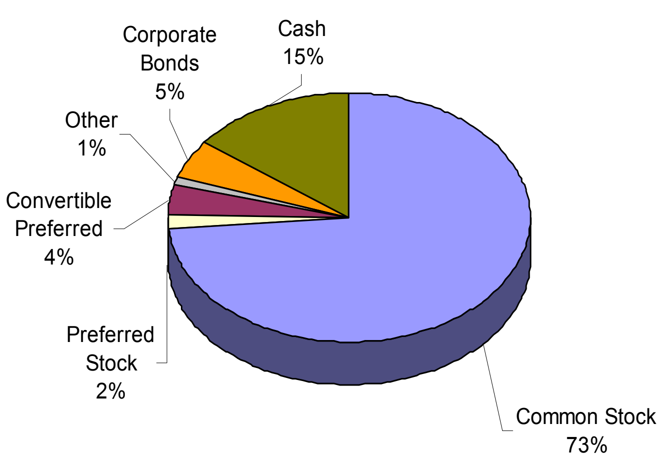
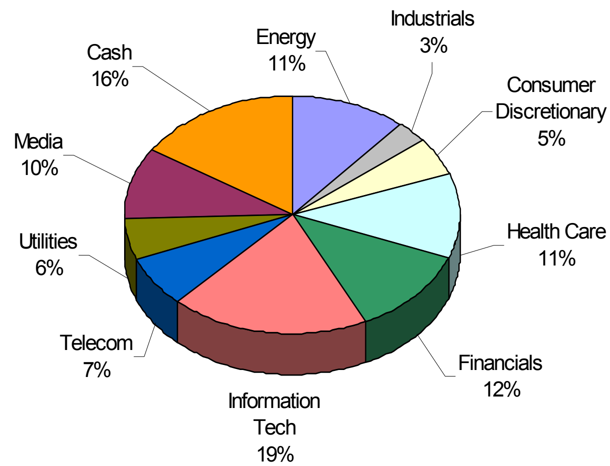


fig 2. Sector Diversification (Capital Appreciation)



than it hit consumers. The Fed's tightening crimped access to investment capital much more than it did access to funds for consumption. Through the cycle, con-sumers have continued to be able to borrow, and have enjoyed lower rates (particularly against higher valuations on their real estate holdings). But the credit cycle led to capital markets that were nearly completely closed to businesses. As a result, industrial capacity – par-ticularly in capital-intensive industries like commodity production – has failed to keep up with demand, translating to more pricing power for producers, and the modest increase we have seen in inflation.

With the credit contraction now largely behind us, I expect higher investment to ease those production bottlenecks and contribute to an extended economic advance. Such an outcome should prove positive for investors over the next several years.

-Charles Lemonides CFA

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ValueWorks:

controlling quality assets at compelling valuations

Defining our Philosophy:

At ValueWorks we define value investing as buying the best-quality assets at the best possible prices. We like to think of ourselves as bargain hunters: it is our goal to pay only $0.50 to $0.75 for $1.00 worth of assets. We evaluate the component parts of a company, assigning each of its assets a dollar value that, when added together, comprises the underlying value of the company; if this is higher than the company's stock price, we consider it an investment opportunity.

Defining our Process:

1) Identification. We monitor the financial markets to identify securities that match our investment criteria—focusing on opportunities that appear misunderstood by the general market.

2) Appraisal. First we identify the assets; then we appraise them. This allows us to determine the company's *underlying value*. We then decide whether the assets are of high quality and therefore likely to appreciate over time.

3) Assessment. Here we assess any claims against a company's assets; we then compare the market price of the claims to the company's *underlying value*. If a particular security trades at a discount, we identify factors that could eliminate the valuation gap and increase its price. We then make a decision on the purchase of the security.

4) Re-Evaluation. We continuously monitor our positions to determine if our original investment thesis still applies, taking necessary action to optimize our portfolio.

5) Exit. We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

Our objective is uncomplicated, but achieving it requires a high level of research, expertise, discipline and independent judgment. By applying this framework consistently we remove emotion from the investment decision making process, enabling us to capitalize on inefficiencies built into the market.

About our Portfolio Structure:

We believe risk can be better contained through educated security selection than through over-diversification. Consequently, our position sizes range between 3 – 5 %of the overall portfolio value. Fully invested portfolios tend to hold 25 – 35 individual investments.

We enter investments that we view as 25 – 50% undervalued and sell them when we see them as fairly priced. Our anticipated holding period tends to be one to two years which results in only modest portfolio turnover.

Because our decisions are based on research and sound fundamentals we view depressed price action on our securities as buying opportunities rather than sell signals.

We use senior debt and preferred instruments—offerings that can be easily misunderstood by traditional equity or fixed income investors—to gain equity type returns on safer vehicles.

About our Client Services:

ValueWorks provides independent investment management on an individual account basis. Our clients receive the benefits of owning securities directly, coupled with the advantages of having a dedicated portfolio manager.

Working directly with your financial consultant, we evaluate your investment profile and build a plan designed to meet your specific goals.

As a high-end investment alternative, you receive:

- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements and investment needs
- Comprehensive quarterly performance reporting

Working within the framework of our value investment discipline, we build portfolio's that cover a wide spectrum of risk-tolerance, from aggressive to much more conservative and income oriented.

ValueWorks: Performance Review

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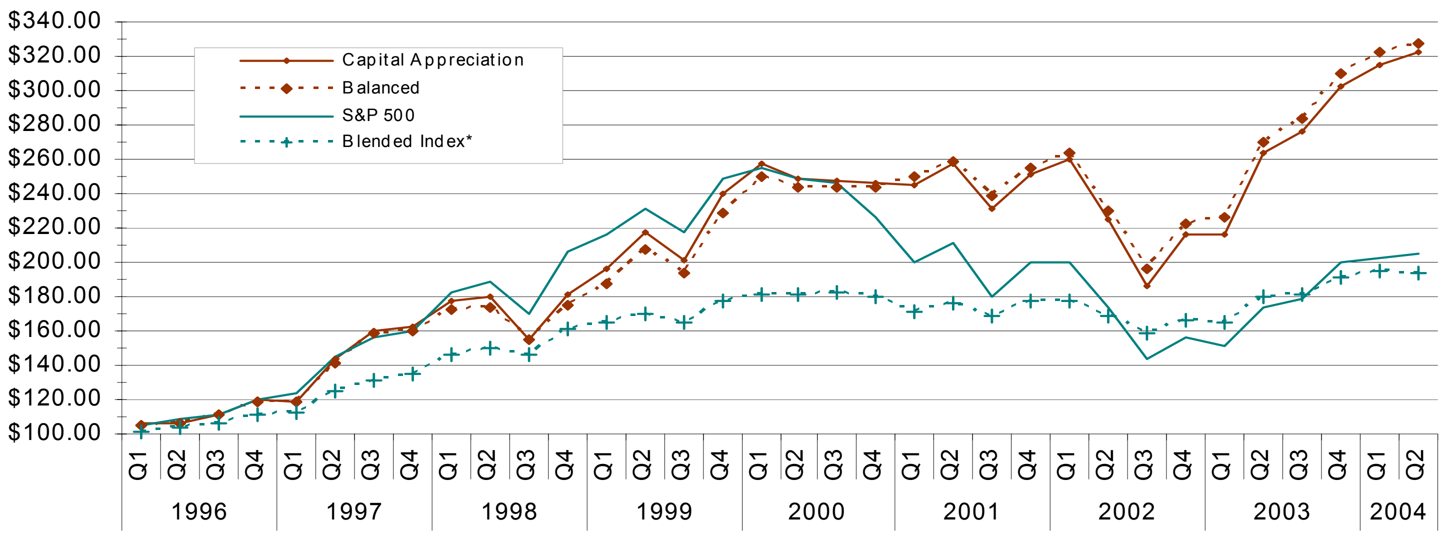
2nd Quarter: March 31—June 30, 2004

Historical Growth of $100 (gross of fees)



Performance Data

	ValueWorks' Capital Appreciation Composite			ValueWorks' Balanced Composite		
	Gross of fees	Net of fees	S&P 500	Gross of fees	Net of fees	Blended index*
Return 1996 - Present	**14.78**	**12.88**	**8.80**	**14.97**	**12.96**	8.12
Rolling 5 Year Return	8.16	6.58	-2.43	9.50	7.61	2.68
Rolling 3 Year Return	7.78	6.24	-1.09	8.08	6.25	3.17
Rolling 1 Year Return	22.39	20.66	17.59	21.05	19.15	8.18
2004 YTD Return	6.55	5.82	2.61	5.56	4.74	1.40

*The 'blended index' is 50% S&P 500 and 50% Merrill Lynch Domestic Master Bond index.

The above benchmark indices are unmanaged indices. The benchmark performance numbers reflect the reinvestment of dividends and interest but do not reflect the deduction of any fees or expenses. ValueWorks' value investing style is not limited to the securities in any of the above indices and utilizes specific investment techniques which are not utilized in the above indices and which may or may not increase volatility. Returns include all dividends, interest, accrued interest and other cash flows received as they may result from the implementation of a particular investment strategy. Trade date accounting has been used. Results for the full period are time weighted. Accounts are included in composite at the start of the first full month under management. Exiting accounts are included through the last full month under management.

"Top 10 Holdings" are complied from the aggregate holdings of the ValueWorks' Capital Appreciation Composite. Neither this nor any other reference to specific securities in this publication is intended to be a recommendation to purchase or sell these or any other securities.

The Capital Appreciation Composite consisted of 129 accounts and $59,140,028 in assets as of 6/30/03: the Balanced Composite consisted of 93 accounts and $55,851,633 in assets as of 6/30/03. Combined, these represent over 99% of the accounts, and approximately 85% of the assets managed by ValueWorks LLC. These results were generated at other firms prior to the fourth quarter of 2001. Results for other composites are available upon request.

Past performance is not a guarantee of future results.