



INVESTMENT COMMENTARY

Market Review

The US stock markets generally recovered from first quarter declines to end the second quarter approximately even on the year. The decline in “Foreign Stocks” primarily reflects the appreciation of the US dollar relative to most major currencies¹. In local currencies, most foreign stock markets were substantially positive during the second quarter.

Bonds had a very strong quarter, despite two more ¼ point increases in short-term rates by the Federal Reserve Board (rates on your cash and money market balances have increased). The yield on the 10-year US Treasury bond fell steadily from 4.5% to 3.9%² during the quarter³. We believe the sustained low long-term interest rates are primarily due to large amounts of global liquidity, i.e. Asian central banks, corporate balance sheets, and modest return expectations from alternative investments.

Comparative Performance Indices				3-Year Average Annual Return
Total Return for periods ending June 30, 2005 ⁴		Quarter	Year	
U.S. Stocks	Russell 3000 Index	+2.2%	+8.1%	+9.5%
Foreign Stocks	MSCI EAFE Index	-2.0%	+11.0%	+9.5%
Taxable Bonds	Lehman Brothers Aggregate Bond Index	+3.0%	+6.8%	+5.8%
Municipal Bonds	Lehman Brothers Municipal Bond Index	+2.9%	+8.2%	+5.9%

The indices above are representative of investment asset classes. The Lehman Brothers Aggregate Bond Index is composed of U.S. Treasury, U.S. government agency, corporate bond, and mortgage-backed securities. The Lehman Brothers Municipal Bond Index is composed of general obligation (GO) and industrial revenue bonds issued by state and local governments. The Russell 3000 Index is composed of the 3000 largest U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market. The Morgan Stanley Capital International Europe, Australia and the Far East (MSCI EAFE) Index is a widely followed group of stocks from 20 countries, excluding the U.S. It is not possible to invest directly in an index.

During the second quarter, corporate earnings, the primary driver of stock prices, continued to increase at double-digit rates. First quarter 2005 pretax NIPA profits were up almost 14% over the first quarter 2004 as real GDP was revised upward to 3.8%⁵. We believe that the economy and corporate profits remained strong during the second quarter.

Current Outlook

Many commentators have expressed dire concerns about a “bubble” in real estate and its impact on the economy and financial markets. Is there a “bubble”? We do not think so. During the past several years, we have increased our exposure to real estate through the purchase of real estate investment trusts (REIT), companies that own and manage real estate properties. Our portfolios have benefited greatly as our REIT holdings have delivered outstanding total returns comprised of both high dividends and capital appreciation. Moreover, from a portfolio management perspective, real estate remains an important asset class due to its low correlation with the investment returns of stocks and bonds. Therefore, real estate holdings are important

¹ The US dollar has appreciated by 12% year-to-date vs. the Euro, Wall Street Journal, July 1, 2005.

² Yahoo Finance

³ See our January 2005 Investment Commentary for an explanation of how this divergence can occur.

⁴ Data from Lipper and WSJ Market Data Group as published in the Wall Street Journal, July 5, 2005.

⁵ Bureau of Economic Research



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diversifiers, lowering the risk of portfolios. Though real estate bubbles may crop up in certain local markets and the rate of price increases may slow, a national real estate bubble is unlikely for at least four reasons:

1. Employment, income, and household formation, key drivers of real estate valuations, continue to grow.
2. The current environment of slowing rising interest rates and inflationary fears should be favorable for real estate valuations.
3. Foreign demand for US real estate should continue as Asian economies seek more aggressive ways to recycle their US dollar earnings (remember Japan in the 1970's).
4. Real bubbles are usually not recognized until after they burst. If people are calling it a bubble in advance, then most likely it will not burst!

Speaking of "bubbles" ... what about oil prices? The evidence continues to mount that fundamental factors are seriously out-of-sync with current oil prices. Current oil prices appear to be set by traders and speculators in the commodity markets. The fundamentals tell a very different story. Crude oil inventories in the United States were approaching 10-year record levels at the end of the second quarter⁶. Cambridge Energy Research Associates recently predicted that increased worldwide exploration activity could increase global production capacity by 16 million barrels a day by 2010, creating a global oversupply of 6 to 7½ million barrels a day, and driving prices below \$40 per barrel⁷. The sharp divergence of opinion between industry experts, who track the fundamentals, and energy futures traders, who trade for profits, is striking. The differences may have a lot to do with the ease and speed of trading a futures contract as compared to both the time and difficulty of actually producing a barrel of oil and to the time and cost of converting from oil to another energy source. Usually, fundamental factors are eventually reflected in markets. Therefore, we maintain our expectation of sharply lower oil prices during 2006.

The ability of the economy and the stock market to withstand high oil prices, the difficult situation in Iraq, a terrorist attack in London, and rising short-term interest rates is encouraging for the prospects for stocks during the second half of 2005. The Federal Reserve Board appears to have done a masterful job in slowing the growth of the money supply, gradually raising interest rates, and controlling inflationary expectations. Market recognition of the oil price "bubble" and an end to the Federal Reserve Board's interest rate increases could prove to be positive catalysts for the stock market.

Consequently, our stock market outlook is unchanged from that which we expressed in our April Investment Commentary:

We maintain our view that 2005 will be the third consecutive year of positive stock market returns (though probably the lowest of the three years). Here's why ... we expect that 1.) oil prices will fall substantially in the next year; 2.) inflation will rise moderately; and consequently 3.) long-term interest rates will not rise fast enough to significantly inhibit economic growth.

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⁶ U.S. Department of Energy, Bear Stearns.

⁷ Cambridge Energy Research Associates as published in Wall Street Journal, June 22, 2005.