



MANCHESTER CAPITAL MANAGEMENT LLC

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Market Outlook

By Ted Cronin, CIO

The stock market is climbing a familiar wall of worry between problems and profits. The indexes have exhibited big up days and down days so far this year, but are currently approaching multi-year highs.

The problems are well known and include the price of oil, the deficits, and the dollar, all of which threaten inflation and thereby might slow the economy. But profits are pulling the averages back up again. Corporations are achieving excellent earnings, corporate profit margins are at record levels, productivity remains strong, and housing starts are at 20-year highs.

More good news comes from improving global conditions. International tensions have eased as successful elections in Iraq and Palestine offer the hope for peace in the Middle East. Events in Syria, Egypt, Lebanon, and even Saudi Arabia suggest the spread of democratic principles. Recent efforts by the Administration with our European partners offer the promise of more effective international cooperation. Financial markets do well when there is peace and stability. They thrive when there are healthy alliances.

Further, tax cuts in the US have caused the American economy to accelerate strongly. Meanwhile, our partners in Europe and the East are struggling. Japan has fallen back into recession after several quarters of growth. Germany contracted 0.2% in the fourth quarter and Italy shrank by 0.3%. This year, the European Union will underperform and be lucky to achieve a 1.7% GDP. It is no wonder that Europeans are increasing investments in the US and have driven certain real estate markets to excess valuations.

While the policies of the EU hamper growth, China, India, and many other emerging markets are endorsing growth and enjoying continued foreign investments. These developing countries are achieving remarkable success managing some of the highest GDP growth rates (7-10%) possible and thereby raising the standard of

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living, health, and aspirations for one-third of the people on the planet.

Our original working hypothesis for 2005 was for modest stock market returns in the US and slowing economic growth. Data at the end of 2004 suggested a regression of market returns below the trend line as interest rates increased and corporate profits slowed, but much has happened to suggest a more favorable outlook.

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Fourth quarter GDP was upgraded from 3.1% to 3.8%. Money remains cheap to borrow and abundant. Capital spending plans are up sharply. We are seeing an upsurge in both wage growth and wage income. A virtuous economic circle could be forming, as a new corporate optimism triggers greater spending leading to top line growth in revenues, leading to better earnings that prompt more expansion.

Many things could still go wrong (war, terrorism, excessive interest rates hikes, etc.), but we might be surprised in 2005 by a 4% plus economic growth and powerful markets. Growth sectors, the resource arena, and the emerging markets internationally are attractive.



Indexes: Are They All Built the Same?

By Jim Mirenda, Managing Director, Manchester

An important component of successful investment management is evaluating portfolio performance. We make every effort to provide informative, concise and complete performance information to our clients. We are also charged with ensuring that our investment selections, whether through individual securities, mutual funds, or separate account managers, retain superior risk-return characteristics.

Reviewing performance and risk against a standard benchmark is one method of judging the merits of an investment. While indexes serve as valuable tools when used as either benchmarks or investments themselves, they are far from a panacea. There are hundreds of indexes that can be used and it is important that an appropriate index is selected and that its components are clearly understood.

The universal concept of indexing is diversification. We look to indexes for information on how specific market sectors perform over time, thus eliminating the importance or risk of any single position. By contrast, active investment managers hold fewer positions than might be contained in indexes. The goal is to hold the better performers and eliminate the worse performers versus a given index. They are paid for their skill in choosing the better performing investments.

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Despite our implicit trust in indexes there are no regulatory guidelines for structuring an index. Almost all indexes are formed and maintained by a for-profit company (Standard & Poor's, Dow Jones, Morgan Stanley, Lehman, Russell) and the acceptance of an index is more likely a function of marketing than of actual effectiveness. For instance, the commonly used Dow Jones Industrial Average is one of the oldest indexes and most recognizable. Despite the fact that it maintains a very limited profile of US companies, it is one of the best-known market indicators in the world, partly due to its widespread familiarity to many generations of investors.

The technical differences between indexes can be striking. One of the most important characteristics surrounds the weighting of a single position in an index. There are three main weighting methods: price-weighted, market value-weighted, and equal-weighted.

Price-Weighted: This method uses an arithmetic average of current prices, where high priced stocks have a relatively greater effect on the index than an equal change in a low-priced stock. *A price-weighted index assumes you purchase an equal number of shares of each stock.* The problem with this method is that a higher stock price is not necessarily a reflection of a stronger company; share price is easily manipulated by the number outstanding shares. An example of this method is the Dow Jones Industrial Average.

Market Value-Weighted: This method sums the market capitalization of each stock and divides by a similar sum calculated during the selected base period. *This value-weighted index assumes that you make a proportionate market value investment in each company.* The problem with this method is that larger market capitalization firms have a greater impact on the index compared to their smaller counterparts.

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For instance, in 2000 the S&P 500, which uses this method, was dominated by the top 25 stocks. While representing just 5% of the number of stocks in the index, they accounted for 44% of the market capitalization and thus almost half of the index performance. The 'market' appeared to be performing well while these stocks were booming, while the performance of the remaining 95% of the members contributed relatively less to overall results. This is hardly the broad diversification that a prudent portfolio manager would advocate.

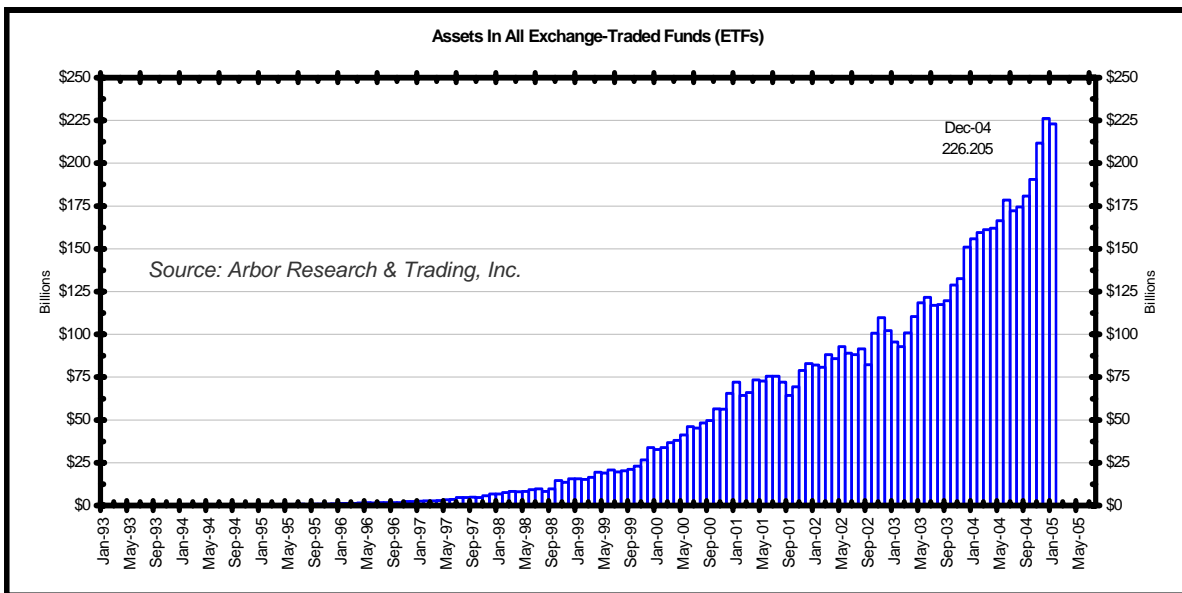
Equal-Weighted: In this method all stocks carry equal weight regardless of market value or price. *An equal-weighted index assumes you make and maintain an equal dollar investment in each stock.* This places a bias towards the smaller companies in the index. An example of an equal-weighted index is the Value Line Composite Average.

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Aside from pricing methodologies, indexing firms employ different guidelines for including securities in an index. Standard and Poor's mandates four quarters of positive earnings, while Russell does not mandate that companies have positive earnings. Thus, there may be dramatic differences in the quality (viability, management, and profitability) of companies that make up an index. Additional indexing methods may include: the number of stocks used (Russell 2000), price to book value measurements (S&P Growth), and concentrated sectors indexes (Energy, Healthcare).

While indexing has been around for decades, Exchange Traded Funds (ETFs) are the latest indexing products to catch the investment wave. They track various indexes and trade intra-day like stocks. Additionally, they may have better tax manageability than traditional open-ended mutual funds. The chart below shows the explosion of assets invested in ETFs which are now approaching a quarter of a trillion of dollars invested!

There is, unfortunately, no perfect market index. Each index and indexing methodology has its own benefits and detriments. MCM is cognizant of these differences and remains focused on providing the best risk/return parameters for our clients through a diligent investment process that includes broad diversification and well-screened investments.



Clients are reminded that the deadline for filing 2004 tax returns is April 15, 2005. Please feel free to contact us if your accountant requires additional information to complete your return.