Manchester Capital Management LLC

December 3, 2004

In this Issue:

- Market Outlook
- Manager Tenure
- Important Year-End Reminders

Market Outlook

America's economy continues to do well. A recent highlight was the excellent employment report showing a strong job recovery, with over 337,000 new jobs created in October and unemployment hovering near a historically low 5.5%. Personal income is growing while inflation remains in check. The stock market has responded to this good news and the election outcome with a strong rally. As we anticipated in our prior commentary, most well structured portfolios are providing solid returns for the second year in a row.

Indeed, we have increased our estimates for corporate earnings in 2004 and 2005. The following chart shows graphically the strength of the corporate earnings rebound after the 2000 slowdown. Earnings grew 18% in 2003 and are on track to grow 20% this year. Next year should see more normalized growth of about 7%, but in combination with gains in productivity and spurred by stronger exports, we could have stock market price appreciation of around 10%. The holiday season ahead is often positive for stocks, and the current rally should continue into the New Year.

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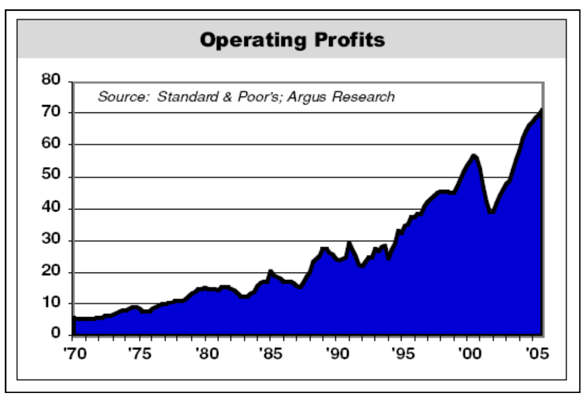

Going forward, however, I have concerns about what I perceive as a change in the Administration's attitude toward the greenback. Since its high in 2002, the dollar has declined over 13% against a broad range of currencies and almost 40% against some major trading partners. As I write, one dollar is only worth € 0.77, versus more than €1.30 only a few years ago.

3657 Main Street
Manchester, VT 05254
(802) 362-4410

30 Main Street
Burlington, VT 05401
(802) 951-2512

1155 Coast Village Road
Montecito, CA 93108
(805) 969-5670

(Continued from page 1)

The decline is spurred by America's trade imbalance and the growing deficit between what we buy from abroad (too much) versus what we sell abroad (too little). This imbalance has been growing for more than a decade, and causes the US to be ever more dependent on foreign capital to finance our spending habit. We are now overspending at a rate of almost 6% of our GDP, which is a rate that often results in serious problems for spendthrift economies.

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One solution is for US consumers to spend less and save more, but this has proven difficult. As individuals, our saving rate is so low as to be reckless. More people are borrowing against their home equity rather than salting away money in savings accounts. Collectively, our government is equally irresponsible. The recent spending bill passed by the Congress was another example of pork and excess where every constituent demands to be fed. Only a line-item veto could hope to restrain these back room deals at the fiscal buffet, but that appears politically impossible.

Another solution to the widening deficit is stronger global demand so that the US could sell more aboard. Lately, such prospects are dim, as our trading partners in Europe and Japan have continued to under-perform. Their economies are growing at only half the pace of the US, and they suffer from structural problems with labor, productivity, and competitiveness. The weaker dollar makes US products less expensive for foreigners to purchase, but foreigners don't have the ability to buy.

A decline in the dollar's value could work to US investors' advantage.

Recently, the Chairman of the Federal Reserve has spoken out about what he calls our "worrisome" trade deficits. The official Administration policy continues to support a strong dollar policy, but lately I have sensed an alarming shift in comments made by Treasury Secretary John Snow toward benign neglect of the greenback. My fear would be that any sudden shifts in currency valuations could spark a crisis in the financial markets and investors, as in the 1970s, would sell US securities aggressively due to uncertainty about the value of the dollar.

In the 1980s, the trade-weighted value of the dollar declined by 40% without ill effects, so there is a precedent for a gradual solution to these imbalances. As investors, we should be encouraged to diversify portfolios toward foreign allocations and US multi-national companies that benefit from a decline in the dollar. It is both excellent protection and opportunity. A decline in the dollar's value could work to US investors' advantage as long as the changes are deliberate and foreseen.

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Manager Tenure - A Predictor of Success

By Vito Gioiello

We have longed preached to clients that the prime determinant of investment results is asset allocation. Put simply, the lowest quartile bond manager bested the highest quartile large cap growth manager in 2001 and 2002. There are few substitutes for being in the right place at the right time. Unfortunately, that's a poor investment strategy. We manage the risk of being in the wrong place at the wrong time through asset class diversification and understanding the client's time horizon.

Having said that, at the asset class level, it's important to communicate that the combination of judgment and investment discipline are of immense value in picking solid mutual funds. We work hard researching funds that exhibit "predictors of success." While not guaranteeing top percentile results, when taken together, these attributes make success a far more likely outcome. These predictors include consistency of return over three and five year periods, how closely they stick to their investment objective, turnover, expense ratio, loads, and fund size. There is an 80/20 rule working in our analysis. Although quantitative measures make up the largest share our fund analysis, there is room for qualitative judgment.

Here, we'd like to focus on manager tenure, or how long the current manager or team has been in place. We see it as one of the easiest, yet most overlooked, metrics. Simply put, it does no good to purchase a fund with a great five-year track record if the manager has been replaced, but a great many investors don't view the hold decision as just a variation of the buy decision. By this, we mean that if a fund announces a manager change, the holding should be viewed as a new purchase. Too many investors view manager changes as a non-event saying, "I'm buying the firm, not the manager." While we understand the mentality, we don't agree with the conclusion. There are only so many opportunities to add performance so it's imperative that investors view management changes as a decision point.

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Too often a manager is replaced with what we believe to be insufficient disclosure. That's not a good sign. In fact we view it as simply bad business. We see too many instances of top performing managers let go in what could only be seen as a cost-cutting move. Assume a manager is hired when the fund has $25 million in assets. With great stock picking ability he or she racks up a great five-year track record and drives the fund assets to $1 billion. He can then be replaced at a fraction of his salary and bonus all to the detriment of the current investors who are stuck with a what's on it's way to becoming a mediocre fund. Remember, the three-year performance number won't be materially affected for at least one year. It's depressing how often this occurs.

(Continued from page 3)

Now for a few observations:

- While predictors of success are analyzed individually they actually work in conjunction. For example, funds exhibiting more modest expense ratios tend to have better performance just on the basis of the lower fees. As to manager tenure, Porter and Trifts (1998) found that managers with ten-year track records do not perform better than those with shorter records proving tenure cannot be used as a stand alone metric.
- Three and five year performance are good predictors because they allow a manager's ideas sufficient time to prove themselves and also show performance over the majority of a market cycle. Conversely, one-year performance is a poor predictor. It is also the most widely followed performance metric. Most recent quarter performance is of little use.
- Lemik and Satish's 1996 study of fund managers found that managers with long-term records tended to construct less risky portfolios, had lower turnover, and better performance.

In conclusion, as manager tenure shows, predictors offer investors a higher probability of success rather than a foolproof indicator. Over time, such incrementally better returns can add up to solid out-performance.

Important Year-End Reminders

Tax-Efficient Portfolio Management

It is hard to believe that year-end is fast approaching! To ensure that any and all tax-related concerns are addressed prior to year-end, please contact us if you have any questions or information that could aid in the tax-efficient management of your portfolio.

Year-End Charitable Giving

Please remember that if you wish to make 2004 charitable contributions of stock or cash you must contact us by December 27, 2004 in order to ensure that transactions are executed before year-end. Due to custodial constraints, requests received after December 27, 2004 will not necessarily be completed before year-end.

Best Wishes For A Happy and Healthy Holiday Season