

WEALTH MANAGEMENT ADVISORS, INC.
Second Quarter Investment Commentary
July 2005

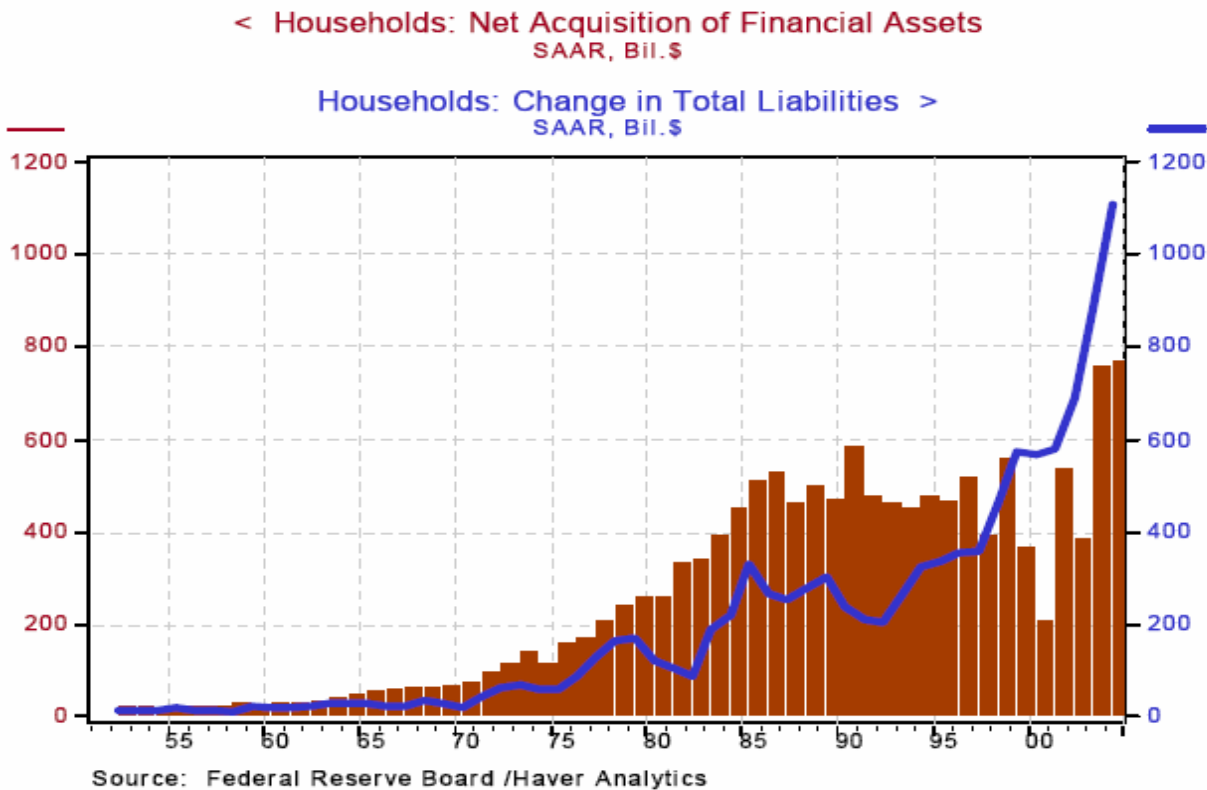
Quarter in Review

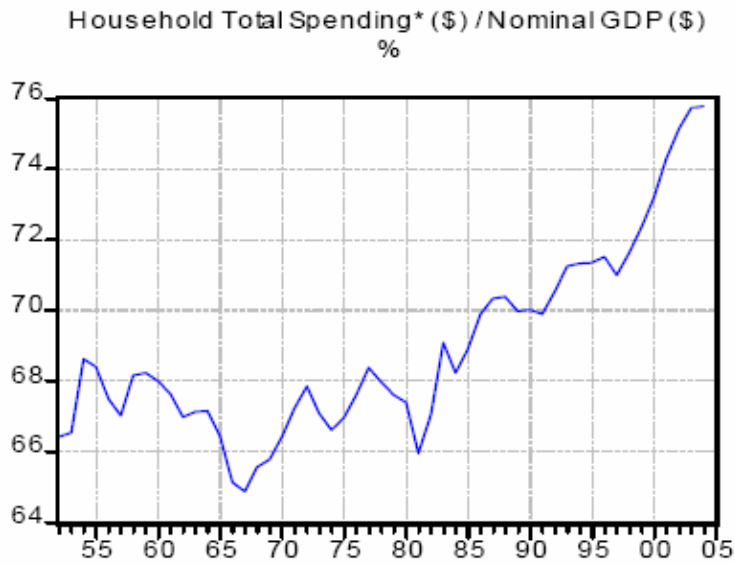
While the first quarter started out weakly, a rally, starting near the end of May, gave us hope that the stock market was awakening from a slumber. Both Bill Gross, the “Bond King” at PIMCo, and Stephen Roach, the chief economist at Morgan Stanley, reversed their opinions on interest rates, saying inflation and the economy were slowing to a moderate pace, and rates would soon reflect that slowing.

Even Allan Greenspan was perplexed at the movement of interest rates during the second quarter. While the Federal Reserve continued to increase short-term rates, longer-term rates declined, giving the mortgage refinance industry new life, and dropping the yield on the 10-year U.S. Treasury note below 3.8%, only fractionally higher than the 2-year note. Opinions on current interest rate structure are varied, and it is probably due to a combination of factors.

The Indomitable U.S. Consumer

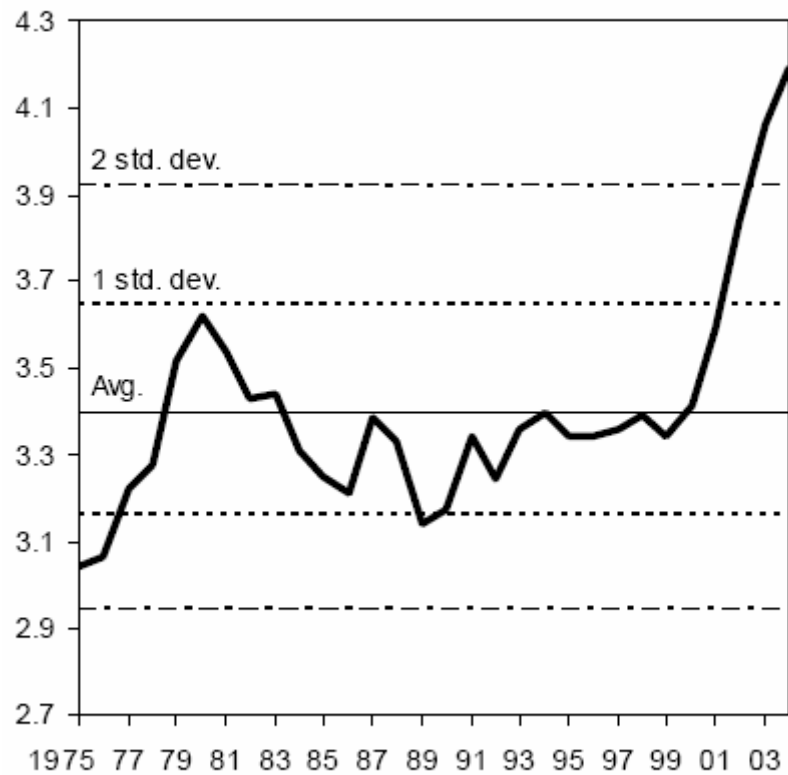
We may have gone a little overboard on the charts this time, but it appears more evident as time goes by that the American consumer is continuing to fuel the world’s economy, and the ability to do this is closely tied to appreciating home prices, not gains in wages. In the 1990’s consumers used inflated stock portfolio values to justify spending, and in this decade, inflated home prices are being used to subsidize people’s lifestyles.





* Sum of Personal Consumption and Private Residential Investment Expenditures

United States: Median Home Prices as a Multiple of Household Income



Sources: National Association of Realtors, U.S. Census Bureau, GMO

“The rhetorical flourishes of America’s central bankers have dug the US economy -- and by definition, a US-centric global economy -- into a deep hole. To this very day, the Fed has never confessed to the Original Sin of condoning the equity bubble. On the contrary, Greenspan & Company have been on the defensive ever since by dismissing the increasingly dangerous repercussions of the original post-bubble shakeout. Far from playing the role of the tough guy that is required of independent central bankers, the Fed has become an advocate of the easy money of a powerful liquidity cycle. One bubble has since begotten another -- from equities to bonds to fixed income spread products (i.e., emerging market and high-yield debt) to property. And financial markets have gone along for the ride -- not just in the US but also around the world as global investors and foreign central banks have rushed with reckless abandon to finance America’s record current-account deficit.”

– Stephen Roach, Chief Economist, Morgan Stanley.

In the first quarter commentary we discussed the co-dependency between China and the U.S. In a conference call on May 24, 2005, Bill Gross of PIMCo stressed that this is affecting interest rates, and will continue to do so for the near future. PIMCo’s contention is that while the U.S. is still the world’s consumer, global demand is lacking and this will slow inflation. What is happening is that cheap Asian labor puts pressure on real wages for U.S. and European workers, limiting the ability of the consumer to spend. (This is why the U.S. consumer has been on a borrowing spree.) This wage pressure situation will continue as China needs to create millions of jobs to avoid domestic strife. This lack of demand and slowing inflation will lead to lower interest rates overall. However, Gross does not believe this will lead to above-average returns in either the bond or stock market. He feels that low-to-mid single digit returns will be the norm for awhile. He also spoke about heightened financial risks in the markets due to hedge funds and derivatives and the torrid U.S. housing market.

Wealth Management Advisors on the Road

For the last several years, we have been invited to the Schwab Explore conference, which is an invitation-only conference, limited to the top 150 advisors who use Schwab as custodian for their clients’ assets. Given that there are about 5,100 advisors nationwide who use Schwab in this manner, we regard this invitation as an accomplishment.

This year, Kevin attended the three-day event, and had this to say upon returning:

The Chief Economist (Robert McNeal) of U.S. Trust, a subsidiary of Charles Schwab & Co., told us that globalization of the world economy will be good for the U.S. economy, despite dire predictions that China will be ruling the globe in very short order. Contrary to what many economists are saying, including the above-quoted Stephen Roach, Mr. McNeal stated that the U.S. consumer is doing well, consumer income is outpacing spending and Americans are actually saving money. Ken Dychtwald, gerontologist and author, discussed how long people will be living (average life expectancy in the year 1200 was 25, in 1900 it was 47 and in 2000 it was 77), that retirement as defined today is a foreign and temporary concept and that people will reinvent themselves in the future, not just retire from the workforce. Bill George, former CEO of Medtronic, Inc., discussed leadership in corporate America and laid much of the blame for the recent business ethics lapses at the feet of Boards of Directors.

Closing Comments

For those of us who sometimes scratch our heads over what is going on in the financial markets, or in the current housing market, here is a great quote from Emanuel Derman, a physicist and financial technician, from his book *My Life as a Quant*.

“Most trained economists have never really seen a first-class working theory, because economics doesn't have any. . .don't mean to say that physics is better. I like economics, but I think that it's rather that finance and financial economics are really much harder. In physics, you are really playing against God, and He sets the laws once and for all, and you are trying to figure them out, and He doesn't really change them too often. And if you figure out what the laws are, then He kind of gives up and says, 'You're right.' In finance, you are really playing against God's creatures, people like us, who value assets based on their ephemeral feelings. . .They overshoot, they undershoot, and they sometimes don't know when they've lost the game. They keep on trying to play, and they keep trying to change the rules on you.”

In our first quarter commentary, we discussed how good the cumulative returns had been for clients in 2003 and 2004. Thus far in 2005, the financial markets have not been as favorable, although it is a far cry from the torture that was 2002. However, after two years of solid advancement in portfolios, any loss, or even the lack of gains, is painful. There is a tremendous asymmetry between the pleasure of a gain and the pain of a loss.

“Once we have emotionally experienced an increase in portfolio value, we feel that it's what we deserve to keep – that we have earned it. If there is a later decrease in value, we feel that something has been taken away from us. Investors who have the mental discipline to focus on the gain in an investment and not on the perceived loss can increase their chances of surviving normal market volatility. They will also be less inclined to let their emotions dictate their investment policy.” – Bruce J. Temkin, *The Terrible Truth about Investing*

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