HOLMES R. OSBORNE III, Inc.

A BETTER WAY TO MANAGE MONEY

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Holmes Osborne Completes CFA!!!

We are pleased to announce that Holmes Osborne has passed the final level of the Chartered Financial Analysts' examination. The CFA is a three level test that is the preferred designation of people in the money management business. The test focuses on ethics, statistics, accounting, and portfolio management. Some famous charter holders include Bill Gross of PIMCO, Abbey Joseph Cohen of Goldman Sachs, and Bill Miller of Legg Mason.

Each level is given only once a year. Thousands of people meet in major cities across the globe for the exam. The test lasts three hours in the morning and three hours in the afternoon. The candidates must wait two and a half months for the results. The odds of passing any one level are about 50%, although only about 32-34% passed levels I & II this year.

A CFA differs from an MBA in that an MBA teaches the management of people and businesses, not investments. A person can have an MBA and have only taken a handful of courses on investments. Many mutual fund companies who hire portfolio managers like the CFA because it is a uniform test. It does not vary from region to region.

Separate Accounts Lead the Way

According to an article in *CBS Marketwatch*, the separate account business has grown to $528.7 billion. Separate accounts are professionally managed accounts in which the client holds individual stocks and bonds. These differ from mutual funds in that separate account owners hold the securities directly. Clients can actually see what securities they own and tailor their portfolio to meet their individual needs.

An example might be if a client does not want to own any tobacco stocks, these stocks would be excluded from the portfolio. In a mutual fund, you do not know what securities you hold.

The separate account business is growing at the pace at which the mutual fund business was growing at in the 1980's. The major brokerage firms now hire outside professional money managers to handle their clients' assets. Smith Barney and Merrill Lynch lead the way in this business with $125.1 and $120.2 billion respectively.

Our clients' accounts are managed in this fashion.

We feel that we have an advantage over the brokerage houses because our clients are cutting out the middle man. At the major brokerage firms, you must pay three parties: the firm, the stockbroker, and the portfolio manager. At Holmes R. Osborne III, Inc., you are dealing directly with the portfolio manager and saving a bundle in fees. In many cases, our fees are half of what the major brokerage firms are charging.

Microsoft and Unum Provident

We are still buying shares of Microsoft and Unum Provident for clients. Microsoft announced that they will offer a $3 dividend for shareholders in November. We originally bought MSFT because they were sitting on about $52 billion in cash. After November, we will probably sell our shares in Microsoft. We would be happy with a 15% to 20% gain on the stock.

Unum Provident announced that their profit this quarter has dropped but we expected this. The stock is still selling at a large discount to book value. We continue to buy UNM. UNM is up slightly from where we began buying it.

Krispy Kreme Doughnuts

If you will recall from our last newsletter, Krispy Kreme was on our Stocks-to-Watch list. Krispy Kreme has fallen from about $20 a share to about $13. We still feel that KKD is too expensive, as measured by the price to earnings ratio. If KKD were to drop to about $10 a share, we would begin buying.

Playboy looking good

We have been considering making a purchase of shares in Playboy. Playboy was founded 50 years ago by Hugh Hefner. The company's earnings have been shaky and PLA trades at about $8 a share. The book value of the company is a little under $5 a share. The stock got all the way up to nearly $17 a share earlier this year.

Playboy has a strong brand and is a household name. Though we would not say that the company has superb management, because of their brand name, we think that at $8 or less, much of the risk has been taken out of the stock.

Short Term Bonds

We have been holding investment grade short term bonds for our clients. These bonds have a yield of 2% or less and mature in a few months. Some of the bonds that we hold include Philip Morris and some municipal bonds. We try to buy corporate bonds for qualified accounts (IRAs, SEPs, Keoghs) that are taxed deferred and municipals for accounts that pay taxes. Municipal bond coupons are sheltered from federal income tax. If the bond was issued in the same state where you live, you will not pay state taxes on the coupons either. Usually, corporate bonds have a higher yield because their coupons are taxable. We like to buy short term maturities because if interest rates rise, our bonds will be shielded from the drop other bonds will experience.

Social Security

According to a June article in the *Wall Street Journal*, the Social Security Trust Fund took in $632 billion in receipts, made $479 billion in benefit payments, and had a surplus of $153 billion. The total surplus at the end of 2003 was $1.5 trillion. The problem is that in three years, the first wave of baby-boomers will be eligible for benefits. In 21 years, 77 million boomers will qualify. In thirty years, the ratio of retirees to workers will be two to one. Social Security is a pay-as-you go plan. This means that the money that you are contributing is not being saved for you specifically. It is first being used for retirees who are drawing benefits. As you can see, this poses a problem for Social Security as things stand.

One of the popular solutions is to raise the amount of income that is subject to social security. Currently, the maximum amount that is subject is $87,900. Another solution would be to cut benefits but this would be extremely unpopular.

President Bush suggested individual retirement accounts much like a 401K that would invest in stocks and bonds. So far, he has made no real push to make this happen.

We recommend that clients do not depend on Social Security for retirement. People should max out their 401Ks, IRAs, SEPs, and other retirements plans. In addition, people should do their best to pay off all debt so they will not be burdened by debt service during retirement .

Stock Option Expensing

If you have been following the news, you have probably heard about the controversy of companies expensing stock options. This is a very tricky subject to understand.

A stock option gives a person the right to buy a stock in the future. As an example, a stock may trade at $40. If the stock reaches $70 by a certain date, the buyer may buy that $70 stock for $40 by having taken an option on the stock. This would be a $30 profit. You can go on the open market and buy options to do this. You must pay a price (called a premium) to buy an option.

The controversy is that corporations are giving their employees these options but not counting them as an expense. In the above example, we will pretend that the option would trade for $5 on the open market. If the corporation expensed these options, then each $5 option would reduce the earnings of the company.

In Europe, expensing stock options is the accounting law. Many American companies do expense stock options now. Recently, legislation was passed by Congress that companies must expense stock options for all employees except the five highest compensated. It is too bad that this law got caught up in the political process. Obviously, companies should have to expense options for all employees.

We do not invest in options at our firm. Because of the risk in an option, we would rather own the underlying stock.

Experience

Holmes Osborne began his career as a financial consultant for Merrill Lynch Private Client Group in Naples, Florida. At Merrill Lynch Mr. Osborne assisted clients in asset management and estate planning. After Naples, Mr. Osborne managed trust portfolios for Merrill Lynch Trust Company (a division of Merrill Lynch's mutual fund division) in Boca Raton, Florida. The trust department managed over $1 billion in clients' assets. After Florida, Mr. Osborne worked in management for Farmers Insurance Group in Los Angeles, California.

Mr. Osborne has a degree in finance from the Martin J. Whitman School of Management at Syracuse University. Licenses held are Series 7, 63, 65, and 26. Member of the CFA Society and Los Angeles Society of Financial Analysts. Mr. Osborne has passed all three levels of the CFA. Mr. Osborne is President of the Syracuse Alumni Association of Southern California.

Fidelity Investments

http://www.fidelityinvestments.com

Clients' assets are held in custody at Fidelity Investments. At Fidelity, clients may have online access and will receive monthly statements.

All clients' information is kept in the strictest confidentiality.

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