GeoVest Advisors, Inc

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On Course

A quarterly Newsletter from GeoVest Advisors

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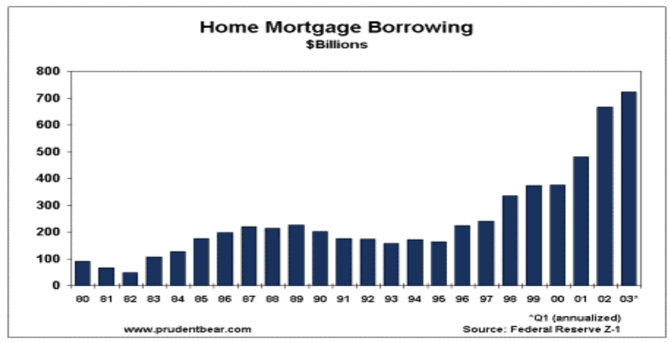
The Hollywood Recovery

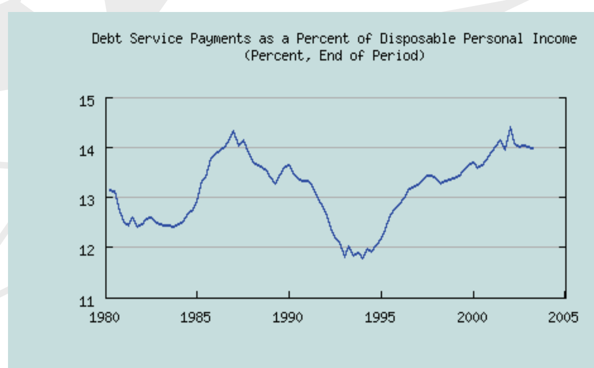
2003 was a great year. Market values are up and people are optimistic about the future. The only problem is that optimism may be misplaced.



I call it the Hollywood Recovery because it looks real on the surface, but like a movie set, there is nothing substantial about it. In truth, the data reflects a lot of spending done on credit, which will have to be paid back later.

A sustainable recovery is a product of optimistic investment, not consumption. It happens when the economy is poised to benefit from some new development such as a technological breakthrough that will make the US more competitive against our trading partners. It happens when people have unmet needs, both material and service-oriented, that are not being met.

Let's start by explaining why the numbers look strong. We had a massive housing and refinancing boom last spring and summer which put a lot of money into the economy. Notice the above chart and the magnitude of the jump in mortgage debt. Not only did people lower their monthly payments by refinancing their mortgages at lower rates, they pulled equity out of their homes so they could spend it on other goods.



Bureau of Labor Statistics

The Economy

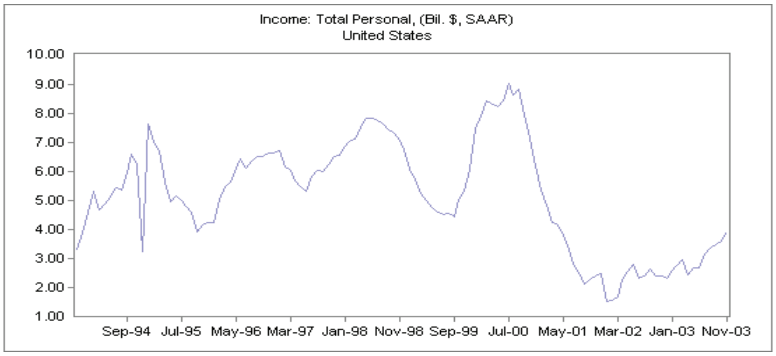
Without question, current economic data is positive. Industrial production is up, housing continues to remain strong, and consumers continue to spend what they make today, and what they expect to make in the future. The problem is, this type of recovery is unsustainable. It will last only as long as credit remains readily available.

This next chart shows how the need to service that debt is cutting into a typical person's paycheck.

Special points of interest:

- The economy is not growing as rapidly as people perceive.
- Asia presents some unique risks to the global economy.
- High quality stocks at reasonable prices are the best choice in the stock market.
- High quality bonds should perform well.

If we are at the beginning of another economic expansion, how will consumers pay for additional purchases? Incomes would have to rise to generate additional purchasing power but that seems unlikely when our jobs are being exported to China and India.



The above chart shows the year over year growth in personal income in the United States over the past ten years. As you can see, our income is not growing as fast as it was during the mid-1990's.

Putting the pieces together, we have a high level of indebtedness, continued job loss, and weak income growth. That's a recipe for loan defaults, and that is why we've been selling our bank stocks.

"Putting the pieces together, we have a high level of indebtedness, continued job loss, and weak income growth."

The Currency Markets

Everyone is talking about the drop in the dollar and how it is a harbinger of higher interest rates. That's the simple explanation. The correct explanation, in my opinion, is the dollar is dropping versus Europe, Canada, and Australia but not versus the Asian economies. The Asian economies, particularly China, are highly dependent on the US consumer as a market for the goods they produce. If they sell all the dollars we pay them for their merchandise, the dollar would fall dramatically. But, that merchandise would then cost more for US consumers, who are averse to paying full price.

For example, if the dollar were to fall 20% versus the Japanese Yen, a new Toyota that previously sold for $30,000 would have to sell for $36,000 to keep profit constant.

The Asian economies are desperately trying to develop their own consumer markets to reduce their dependence on the profligate US consumer. Someday, they will succeed, but it will take many years. In the meantime, they can't afford to raise prices to US consumers.

The dollar is clearly overvalued on a trade-weighted basis and a lot of investors are worried about this deficit. This is why the dollar is falling versus the Euro. But as long as the Asian economies have to continue to sell to the US consumer, the drop in the dollar will be manageable.

Asia

We expect some problems to come out of Asia. China, in particular, is my biggest fear because bad loans threaten to suffocate their banking system. The Economist magazine estimates that problem loans represent 40% of Chinese Gross Domestic Product.

Few investors share this concern over China. Anecdotal evidence suggests that most people are concentrating on the amazing growth the Middle Kingdom is experiencing. In 2003, economists estimate that 40% of their GDP growth came from investment. The Chinese are building a lot of industrial plants and they will need to sell their merchandise to someone. The problem is you can't sell merchandise to someone whose job you just stole.

Besides my concern for the macroeconomic impact of a weak Asia, the companies we own will be impacted. Costco is a great example. Costco purchases a lot of merchandise from China and Japan to sell in its stores. If something were to happen to the economies of China and Japan, Costco would have to buy their merchandise somewhere else, resulting in higher prices for Costco, and ultimately to the consumer.

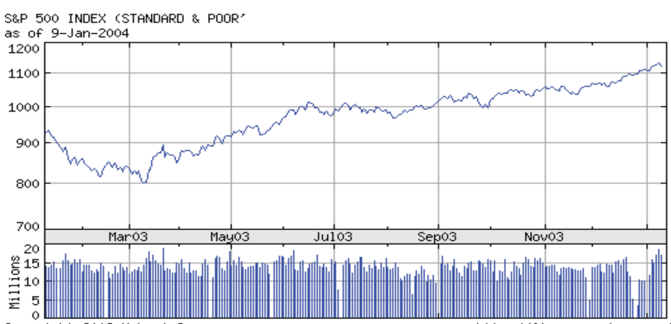
The Stock Market

The level of the stock market at any given time is a function of corporate earnings, economic growth, interest rates, and public emotions. The market rebounded this year because earnings improved, interest rates remain low, public emotions are positive, and the general perception that our economy is going to rebound.

As I stated earlier, I don't believe that our economy is growing as rapidly as most market participants believe it is growing. That's why we continue to add relatively low risk stocks to client portfolios.

Normally, buying low risk stocks in a strong market leads to weak performance. That was not the case in 2003. In fact, on a risk-adjusted basis, our performance was nothing short of exceptional. The reason we were able to post such strong results was that we maintained strict disciplines that allowed us to wait for buying opportunities in stocks that we believe are attractive.

The chart below shows that the rally in stocks started in early April and largely ended by early July. Since July, the market has trended up another 10%



As happy as we are with our results, it is clear that speculators have returned to the market. We've experienced speculation in the Nasdaq stocks, and other cyclicals. Given our expectation for a weaker economy than what is expected, we are looking for ways to position your accounts to benefit from potential weakness in these speculative areas.

The Bond Market

Bonds had a volatile year in 2003. They started off with tremendous gains early in the year, then sold off over the summer. They ended the year a little weaker than they started.

We still like the bond market because bonds tend to perform well when the economy is stable to weak. 2004 will be a year where you will want to maintain the quality of your bond portfolio because we expect credit quality to deteriorate as the year progresses. We favor high quality Treasuries and Municipals.

The GeoVest Approach

Quite simply, at GeoVest we believe in getting paid for the risk we assume in your portfolio. The only way to minimize risk and maximize returns is to understand the securities that you buy and the factors that will influence the success or failure of the investment.

We are not interested in fads or the latest "hot" stock because strong long term performance comes from having control over the decisions we make.

Right now, we are concerned about the strength of the US economy and the potential for crisis in Asia. This means that we will continue to seek companies that provide strong cash flow protection during difficult times and which are trading at reasonable valuations today. You deserve nothing less.

- Philip M. Byrne, CFA

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2003 TAX INFORMATION

Enclosed are records of activity for 2003 for your account. It may not be for a full year if you were not a client for the full year. This report is **only a guide** and should not be used in preparation of your taxes.

Records to Use for Tax Returns

Interest and Dividends

Always use the records as reported by your custodian bank or brokerage account in preparing your tax returns.

For interest and dividends, have your accountant reconcile to the 1099-INT and 1099-DIV reports being sent to you by your custodian or broker. This is the figure the IRS will expect you to reconcile your figures to.

Capital Gains and Losses

Once again, if you had sales, the total proceeds of each sale will be reported to the IRS by your custodian or broker on a 1099-B report. Have your accountant reconcile your sales on Schedule D to this number.

Cost Basis of Securities

Every attempt has been made to capture your original cost basis and adjustments to your cost basis (splits, stock dividends, returns of capital, etc.). However, these figures were generally provided to us by you, your broker, or your accountant when you became a client of GeoVest. Because in most cases we did not have the original purchase confirm, we cannot assume responsibility for accuracy of cost basis. If in doubt, **your accountant can help you ascertain the correct adjusted cost basis.**

In the next issue, we will highlight 2004 limits for retirement account deductions.

For Tax Advice

PLEASE CONSULT YOUR ACCOUNTANT. We will be happy to answer questions about activity in your account, but we cannot provide tax advice. As always, please call us if you have questions about your account. We will be happy to work with you and/or your accountant.

Thank you again for your business in 2003 and best wishes for a happy and prosperous 2004.

Robert E. Reeves and David J. Upson

Enclosures:

(1) Interest and dividends received in 2003 while a GeoVest client. **(Use only custodian/broker Form 1099 statements for tax filings.)**

(2) Realized capital gains and losses in 2003 while a GeoVest client. **(Use only custodian/broker reports of sales Form 1099-B for tax filings.)**