

STRATEGIES FOR THE CHANGING FINANCIAL LANDSCAPE

New Year Update

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“Everything has its season, which does not last forever. The world changes its spots, and the investor must change his.”

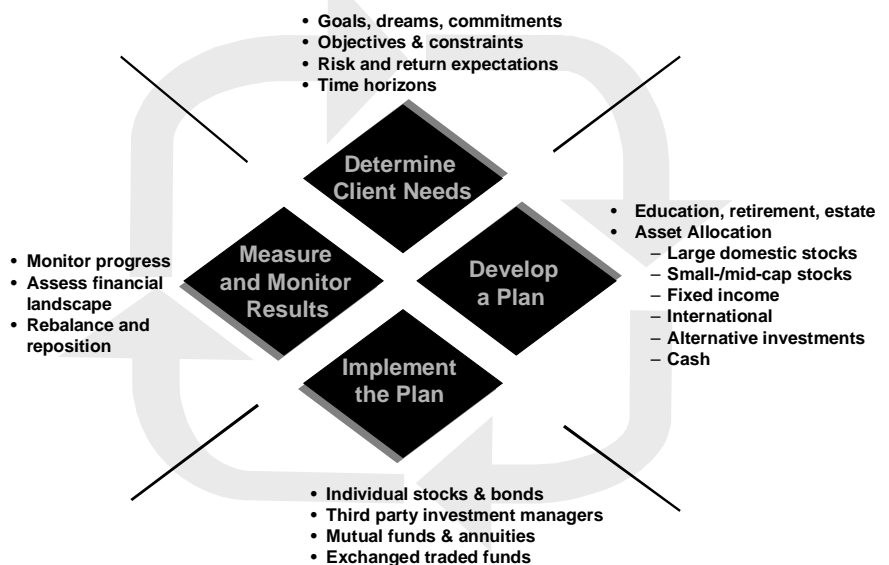
John Train, author of *The Money Masters*

Change has always been a hallmark of the financial landscape. Market, economic and political environments are seemingly in perpetual motion; asset classes and sectors come in and out of favor, with price levels often getting pushed to extremes, both on the up and downside; and depending upon market sentiment, many investors are regularly observed questioning their investment strategy.

- While growth is important, so too is wealth preservation. For many investors, the challenge is to identify and follow a strategy or discipline that allows for personal goals to be obtained, with the flexibility to adjust to a changing landscape.
- In July 2003, we published the first edition of our *Strategies For The Changing Landscape* publication. In August 2003, we published *Fixed Income Strategies For The Changing Financial Landscape*. This current publication presents an update to the July and August editions, highlighting and expanding on many of the concepts illustrated in the two previous publications.

Exhibit 1

FINANCIAL ADVISORY PROCESS



Step 1: Determine Needs

Identifying needs, goals, return expectations and time horizons are among items of primary importance in determining the appropriate strategy for the changing financial landscape.

Exhibit 2

NEEDS ANALYSIS

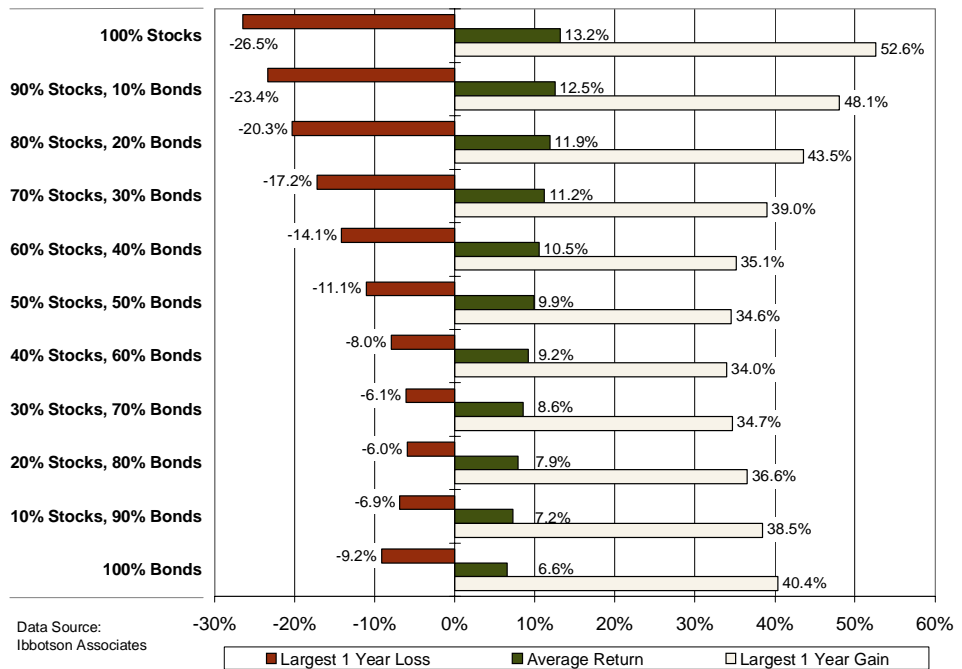


- **Needs Analysis**—Determining needs is the first and crucial step in developing an appropriate investment strategy. This process involves gaining clarity around several objectives. Objectives may include retirement planning, estate planning, paying college tuition, buying a second home, establishing a family trust, tax efficiency, cash management, etc.

Exhibit 3

COMFORT ZONES: DETERMINING THE RIGHT PORTFOLIO MIX

Stock / Bond Mix



Based on returns of the S&P 500 Index and long-term government bonds from 1950-2002

- **Determining Comfort Zones**—Determining the appropriate risk and return expectations are key components of the discovery process. While equities have historically been the best-performing asset class, they have also posted the highest one-year loss over the past 50 years, as illustrated in Exhibit 3. This is an important distinction. Constructing and maintaining a portfolio with a stock/bond mix that provides desired upside potential but exceeds the comfort level for loss in any given year is undesirable. Rather, investors are advised to construct a portfolio that is consistent with both return expectations and personal comfort levels for loss of principal. Exhibit 3 may serve as a useful guide—based on results over the past 50 years—in determining the appropriate stock/bond mix.
- **Exploring The Possibilities**—The broad popular equity markets experienced significant declines in 2000, 2001 and 2002 before rebounding some in 2003. Fixed income, in contrast, posted generally consistent results during this period, as measured by the Lehman Brothers U.S. Aggregate Bond Index. In fact, on average fixed income has posted favorable results dating back to the early 1980s when a secular change occurred from a period of rising inflation and increasing interest rates to moderating inflation and lower interest rates. At issue is whether a secular change with interest rates is again in the making—with inflation rekindling and rates trending upward—resulting in a less-favorable environment for select fixed income securities.

Exhibit 4

MARKET AND SECTOR PERFORMANCE

Index	Close 12/31/03	Price Change				
		2003	2002	2001	2000	1999
S&P 500	1,111.92	26.4%	-23.4%	-13.0%	-10.1%	19.5%
S&P Barra Growth	555.89	23.9%	-24.5%	-13.5%	-22.5%	27.2%
S&P Barra Value	551.93	29.0%	-22.5%	-13.2%	4.2%	10.6%
Dow Jones Industrials	10,453.92	25.3%	-16.8%	-7.1%	-6.2%	25.2%
Nasdaq Composite	2,003.37	50.0%	-31.5%	-21.1%	-39.3%	85.6%
Russell 2000	556.91	45.4%	-21.6%	1.0%	-4.2%	19.6%
MSCI EAFE	1,288.77	35.3%	-15.7%	-21.2%	-14.0%	27.3%
Lehman U.S. Aggregate Bond	1,058.47	4.1%	10.3%	8.4%	11.6%	-0.8%
S&P 500 Sector						
Consumer Discretionary		36.1%	-24.4%	2.0%	-20.7%	24.1%
Consumer Staples		9.2%	-6.3%	-8.3%	14.5%	-16.6%
Energy		22.4%	-13.3%	-12.3%	13.2%	16.0%
Financials		27.9%	-16.4%	-10.5%	23.4%	2.3%
Health Care		13.3%	-20.0%	-12.9%	35.5%	-11.6%
Industrials		29.7%	-27.6%	-7.0%	4.5%	19.9%
Information Technology		46.6%	-37.6%	-26.0%	-41.0%	78.4%
Materials		34.8%	-7.7%	1.0%	-17.7%	23.0%
Telecommunication Services		3.3%	-35.9%	-13.7%	-39.7%	17.4%
Utilities		21.1%	-33.0%	-32.5%	51.7%	-12.8%

Returns do not include dividends

- **Market and Sector Performance:** Exhibit 4 reflects the five-year market and sector performance of the broad popular indices and sectors. The table illustrates how the performance among indices and sectors has varied from year to year.

Exhibit 5

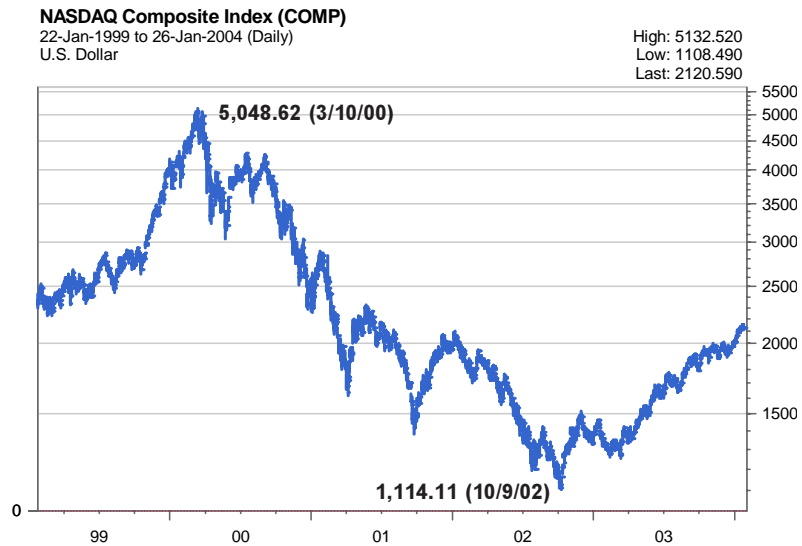
S & P 500 INDEX



Source: FactSet Research Systems Inc.

Exhibit 6

NASDAQ COMPOSITE INDEX



Source: FactSet Research Systems Inc.

- *S&P 500 & Nasdaq Price Trends:* Exhibits 5 and 6 reflect the five-year price trends of the S&P 500 Index and Nasdaq Composite, respectively. The S&P 500 peaked at 1,527.46 on March 24, 2000, and bottomed at 776.76 on October 9, 2002, a 49% decline from top to bottom; the closing price of the Nasdaq peaked at 5,048.62 on March 10, 2000, and the closing price bottomed on October 9, 2002, at 1114.11, a 77.9% decline. This undoubtedly shows how price levels can get pushed to extremes, both on the up and downside.

Exhibit 7

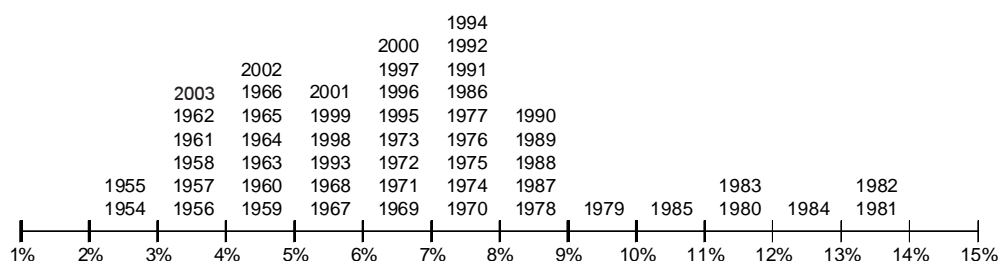
THE IMPACT OF CHANGING INTEREST RATES

Interest Rate Change (percentage points)	One-Year Total Return of Treasuries (by maturity)			
	2-Yr	5-Yr	10-Yr	30-Yr
+3.0	-0.78%	-7.02%	-15.55%	-28.55%
+2.0	0.10%	-3.62%	-9.23%	-18.76%
+1.5	0.55%	-1.88%	-5.86%	-13.36%
+1.0	1.00%	-0.13%	-2.56%	-7.57%
+0.5	1.45%	1.65%	0.97%	-1.37%
0.0	1.91%	3.45%	4.46%	5.26%
-0.5	2.36%	5.28%	8.17%	12.37%
-1.0	2.82%	7.13%	11.85%	20.00%
-1.5	3.28%	9.00%	15.70%	28.17%
-2.0	3.74%	10.89%	19.65%	36.94%
-3.0	4.67%	14.76%	27.85%	56.42%

Source: Bloomberg, Piper Jaffray

- **Interest Rate Sensitivity:** Exhibit 7 reflects the sensitivity of fixed income securities to changing interest rates. This table clearly illustrates how longer-maturing securities are more susceptible to changing rates.

Exhibit 8

TEN-YEAR TREASURY YIELD BY FREQUENCY

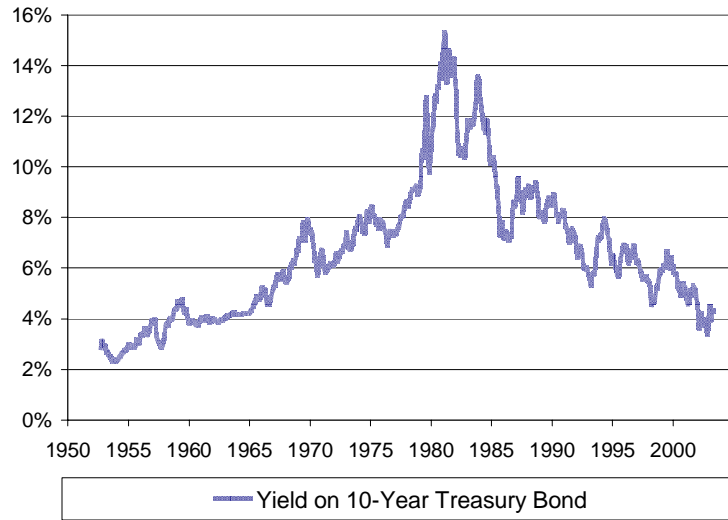
Data Source: FactSet Research Systems Inc.

Annual yields based on the average month-end yield of the 10-year Treasury Bond from 1954 to 2002.

- **Yield Frequency:** Exhibit 8 reflects a bell-shaped curve of roughly 50 years of the frequency of the 10-year Treasury yield. The current 10-year Treasury yield, tending to be around 4.0%, ranks toward the low end of this historical range.

Exhibit 9

YIELD ON 10-YEAR U.S. TREASURY BONDS



Source: FactSet Research Systems Inc.

- **Trend Line of 10-Year Treasury Yield:** Exhibit 9 reflects a 50-year trend line of the yield on 10-year Treasury bonds. To state the obvious, the interest rate environment has changed. From current levels, while rates may trend sideways for the foreseeable future, they are unlikely to trend much lower, especially given the current stimulative fiscal and monetary policies (which may portend future inflation and possibly higher interest rates and corresponding lower bond prices).
- **Fixed Income Assessment:** Importantly, conditions and environments change. Certainly fixed income securities are susceptible to price declines, albeit perhaps not to the degree experienced by equities in recent years. However, the risk profile of fixed income securities has increased following two decades of lower interest rates. While there is no immediate catalyst to suggest rates are likely to trend upwards in the near future, the sensitivity of interest rates is an important component of the needs analysis process. This is not to advise investors to abandon fixed income securities. Rather, it is recommended that investors take a critical look at their fixed income securities to determine their sensitivity to rate changes and to assess whether current holdings remain positioned consistent with portfolio objectives or if upgrade opportunities exist.

Exhibit 10

HISTORICAL RETURNS

	\$1.00 Invested at year-end 1925	Annualized Return
Large Company Stocks	\$1,775.34	10.2%
Small Company Stocks	\$6,816.41	12.1%
Long-Term Corporate Bonds	\$82.48	5.9%
Long-Term Government Bonds	\$59.70	5.5%
Treasury Bills	\$17.48	3.8%
Inflation	\$10.09	3.0%

Source: Ibbotson Associates, based on the period 1926-2002

Exhibit 11

ANNUAL RETURNS OF MAJOR ASSET CLASSES

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bonds	13.15%	56.73%	69.94%	Int'l Stocks 24.93%	Small Value 29.47%	Large Growth 35.92%	Bonds 8.96%	Small Growth 31.19%	Small Value 29.14%	Int'l Stocks 32.94%	Int'l Stocks 8.00%	Large Value 38.35%	Large Growth 23.12%	Large Value 35.19%	Large Growth 38.71%	Small Growth 43.10%	Small Value 22.81%	Small Value 14.02%	Bonds 10.27%	Small Growth 48.53%
Large Value	10.10	Large Growth 32.85	Large Value 19.98	Large Growth 5.31	Int'l Stocks 28.60	S&P 500 31.69	Large Growth -0.26	Small Value 41.70	Large Value 13.81	Large Growth 2.66	S&P 500 22.96	S&P 500 37.58	S&P 500 22.96	S&P 500 33.36	S&P 500 28.58	Large Growth 33.14	Bonds 11.63	Bonds 8.42	Small Value -11.43	Small Value 46.02
Int'l Stocks	7.86	S&P 500 31.73	S&P 500 18.67	S&P 500 5.25	Large Value 25.16	Large Value 25.19	S&P 500 -3.10	Large Growth 41.16	Small Growth 7.97	S&P 500 1.32	Large Value 21.64	Large Growth 37.19	Large Value 21.64	Small Value 31.78	Int'l Stocks 20.34	Int'l Stocks 27.31	Large Value 7.04	Large Value -5.59	Large Value -13.52	Int'l Stocks 39.16
S&P 500	6.19	Large Value 31.51	Large Growth 13.36	Bonds 2.75	Small Growth 20.37	Small Growth 20.17	Large Value -8.08	S&P 500 30.46	S&P 500 7.62	Small Value -1.55	Small Growth 11.26	Small Value 25.75	Small Value 21.37	Large Growth 30.49	Large Value 15.63	S&P 500 21.04	S&P 500 -9.11	Small Growth -9.23	Int'l Stocks -13.94	Large Value 50.03
Small Value	2.27	Small Value 31.01	Bonds 15.37	Large Value 0.50	S&P 500 16.61	Bonds 14.55	Small Growth -17.43	Large Value 24.61	Bonds 7.40	Large Value -1.99	Large Value -1.99	Small Value 25.75	Small Growth 11.26	Small Growth 12.95	Bonds 8.68	Large Value 7.54	Int'l Stocks -14.17	S&P 500 -11.87	S&P 500 -21.09	Large Growth 29.76
Large Growth	-0.95	Small Growth 30.97	Small Value 7.41	Small Value -7.11	Large Growth 11.27	Small Value 12.43	Small Value -21.77	Bonds 16.00	Large Growth 5.00	Small Growth -2.43	Int'l Stocks 6.36	Bonds 18.47	Int'l Stocks 6.36	Bonds 9.66	Small Growth 1.23	Bonds -0.83	Large Growth -22.43	Large Growth -20.42	Large Growth -27.88	S&P 500 28.69
Small Growth	-15.83	Bonds 22.10	Small Growth 3.58	Small Growth -10.48	Bonds 7.89	Int'l Stocks 10.40	Int'l Stocks -23.21	Int'l Stocks 12.50	Int'l Stocks -11.85	Large Growth 2.90	Bonds -2.92	Int'l Stocks 11.55	Bonds 3.63	Int'l Stocks 2.06	Small Value -6.45	Small Value -1.49	Small Growth -22.44	Int'l Stocks -21.44	Small Growth -30.26	Bonds 4.11

Sources: Frank Russell Company, Zephyr Analytics, Wiesenberger, Morningstar, Inc., and Lipper Inc.

Indexes: ■ Small-cap growth: Russell 2000 Growth Index ■ Large-cap growth: Russell 1000 Growth Index ■ International stocks: MSCI EAFE Index
 ■ Small-cap value: Russell 2000 Value Index ■ Large-cap value: Russell 1000 Value Index ■ Bonds: Lehman Brothers Aggregate Bond Index

Indexes are unmanaged statistical composites that measure the various financial markets. An investment cannot be made into an index. Past performance does not guarantee future results.

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- Return Expectations**—Return expectations are often influenced by the recent past performance. Long-term historical returns serve as useful in shaping realistic returns. Exhibit 10 reflects past performance dating back to the 1920s. Equities have been the best-performing asset class. According to Ibbotson Associates, large and small companies have outperformed bonds and cash by a sizeable margin. As illustrated, the annualized returns of large-company stocks, small-company stocks and long-term government bonds are 10.2%, 12.1% and 5.5%, respectively. Exhibit 11 reflects the best- and worst-performing asset classes by year, updated through the end of 2003. Note how the performance of asset classes tends to get pushed to extremes, from best to worse and vice versa. Diversification may help reduce downside risk and increase upside potential.

Exhibit 12

MUTUAL FUNDS TOTAL

	Total Number of Funds				
	1985	1990	1995	2000	2002
Equity Funds	562	1,099	2,139	4,385	4,756
Hybrid Funds	103	193	412	523	475
Bond Funds	403	1,046	2,177	2,208	2,036
Taxable Money Market Funds	348	506	674	703	679
Tax-Exempt Money Market Funds	112	235	323	336	310
Total	1,528	3,079	5,725	8,155	8,256

Source: Investment Company Institute

- Market Volatility**—Market volatility has seemingly increased in recent years. This real or perceived increase in volatility may be a function of a media-driven bias toward focusing on day-to-day market events. Additionally, institutional influences may be adding to volatility. Exhibit 12 reflects the number of available mutual funds, a trend which has increased dramatically over the past 15 years. With the increase in available funds, and with some fund managers focused on short-term performance, this undoubtedly has added to volatility.

Step 2: Developing A Plan

Developing a plan is a key component of the financial advisory process. At the heart of plan development is asset allocation, the allocation of funds among various asset classes, such as stocks, bonds, international securities, alternative investments and cash. The allocation of funds among these various asset classes is the plan that seeks to reach portfolio objectives by maximizing the return for a given risk level, or minimizing the risk for a given return target.

- *Empirical Evidence*—The well-known studies by Brinson, Hood, and Beebower (1986 and 1991) attempted to measure the relationship between the movement of a portfolio and the movement of the overall stock market. They found that *more than 90% of the variability of returns among funds over time is due to asset allocation*. Hence, while asset allocation may not necessarily improve overall portfolio performance, it has proven to reduce portfolio risk or volatility.
- *Risk & Return Objectives*—Several factors contribute to determining individual investor risk and return objectives.
 - Investors with a capital preservation objective tend to have a low risk tolerance.
 - Investors with a current income objective typically want to generate income to supplement earnings for consumption. They also often have a low risk tolerance.
 - Investors with a total return objective may prefer to reinvest both capital gains and dividends.
 - Investors with a capital appreciation objective want their investments to grow above the inflation rate in order to meet future needs. This is associated with the most aggressive risk objective.
- *Asset Allocation Strategy*—Determining the appropriate asset allocation strategy is perhaps as much of an art as it is a science. At Piper Jaffray, the primary asset allocation strategy centers around models characterized by growth versus income objectives. Six asset allocation models are managed and monitored, representing six different objective categories.
 - *Conservative Income*: A diversified investment model designed to provide significant current income with significantly less risk than the equity market.
 - *Income*: A diversified investment model designed to provide current income with significantly less risk than the equity market.
 - *Income & Growth*: A diversified investment model designed to provide income primarily and growth secondarily.
 - *Growth & Income*: A diversified investment model designed to provide growth primarily and income secondarily.
 - *Growth*: A diversified investment model designed to provide long-term growth of capital.
 - *Aggressive Growth*: A diversified investment model designed to help maximize long-term growth of capital.

Asset allocation by objective is used, in part, because of the consistency with industry standards and the corresponding benefits of finding/matching managers with similar objectives. The industry standard is for asset managers to be classified as aggressive growth, growth, growth and income/balanced, income, etc. Offering models consistent with industry standards assists with the implementation process as investors can more easily find managers that mirror their respective objectives.

ASSET ALLOCATION MODELS

Jan 04

Model	Planning Horizon (Years)	Large Domestic Stocks	Small-/Mid-Cap Stocks	Foreign Stocks	Domestic Core Fixed Income	Alternative Investments	Short-Term Fixed Income
Conservative Income	3	15%	0%	0%	41%	0%	44%
Income	5	25%	0%	3%	57%	0%	15%
Income & Growth	7	30%	4%	5%	61%	0%	0%
Growth & Income	10	40%	10%	7%	38%	5%	0%
Growth	15	36%	20%	15%	22%	7%	0%
Aggressive Growth	20	32%	30%	17%	12%	9%	0%

Source: Frontier Analytics, Piper Jaffray

- **Analytical Process**—Each model contains six asset classes, as reflected in Exhibit 13. The newly added asset class, alternative investments, includes managed futures, hedge funds, venture capital, real estate, etc. The recommended allocations for each model are the result of an analytical process conducted with the assistance of Frontier Analytics. The recommended models are based on the principles of the efficient frontier, developed by Harry Markowitz in the 1950s.
- **Optimizing Returns**—The efficient frontier is a representation of the combination of a particular set of assets—such as stocks and bonds—that provide a maximum level of expected return for a given level of risk compared with any other combination of those particular assets at that risk level. Portfolios representing these ideal combinations of asset classes are considered to be efficient.
- **Methodology**—Risk, return and correlation forecasts for each asset class are developed based on selected benchmarks; the Markowitz mean-variance analysis leads to the selection of allocations that attempt to maximize returns for a given level of risk; sensitivity analysis is performed to ensure that portfolios are robust and practical.
- **Strategic Allocations**—The recommended allocations reflect “strategic” allocations, based on the output of the above-noted methodology. The allocations are recommended for investors with longer-term horizons. Exhibit 13 reflects the recommended allocations for each model as of January 2004.

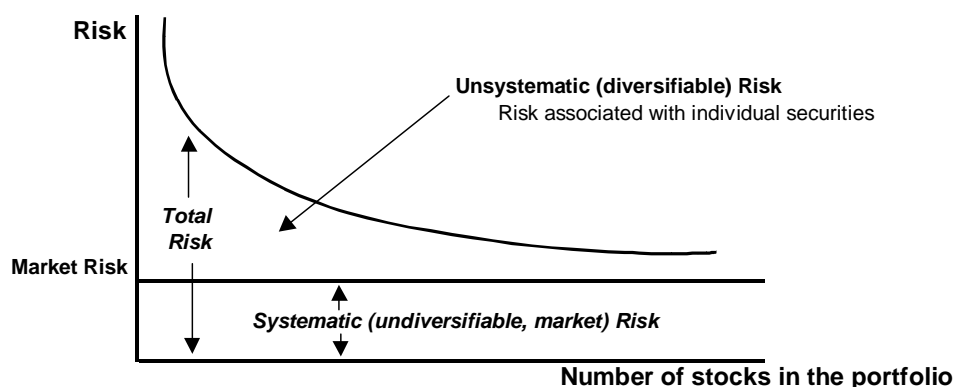
Step 3: Implementing The Plan

Implementation is a key component of portfolio management in the changing financial landscape. Security selection can be implemented primarily through the use of individual stocks and bonds, third party investment managers and/or mutual funds.

- *Varying Features and Benefits*—Individual stocks and bonds, third party investment managers and mutual funds each have advantages and disadvantages over the other, ranging from control of when capital gains/losses are declared, awareness of what is owned and the degree to which the portfolio is positioned specific to individual goals and objectives, professional versus self management, fees, etc.

Exhibit 14

NUMBER OF STOCKS IN A PORTFOLIO



- *Adequate Diversification*—Concerning equities, determining the appropriate number of individual securities to gain proper diversification has been a topic of discussion for years. Some recent studies have suggested that approximately 90% of the maximum diversification benefit can be obtained from portfolios containing 12-18 carefully chosen stocks. A well-diversified stock portfolio is widely believed to contain 30 or more holdings. Exhibit 14 reflects the graphical relationship between portfolio risk and the number of holdings.

Fixed income securities have received increased attention in recent years. In the 2000-2002 period, fixed income securities were increasingly viewed as a safe haven from declining equity prices. More recently, concern is beginning to build over what could happen to fixed income price levels if inflation rekindles and rates rise.

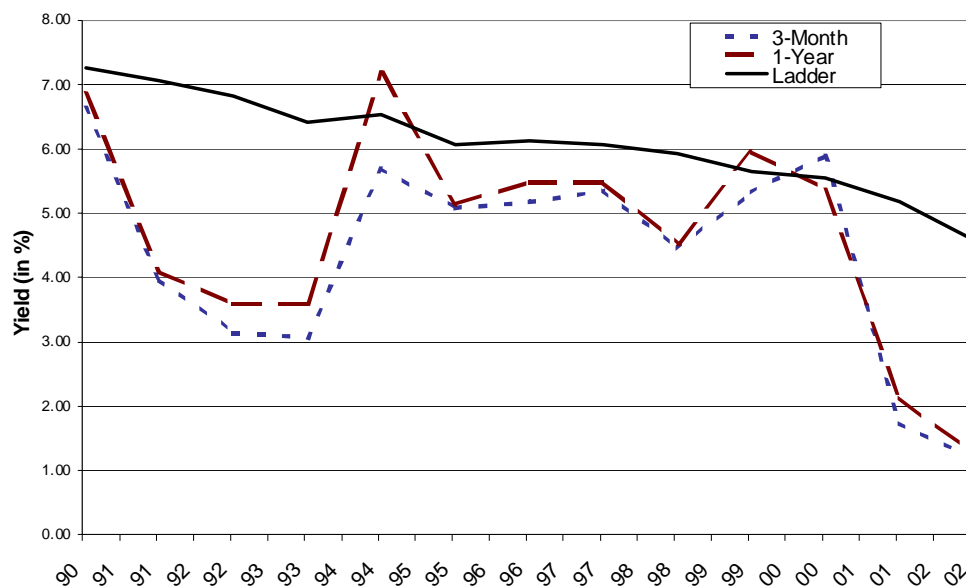
- *Wealth Preservation*—Virtually all effective strategies for the changing financial landscape involve exposure to fixed income securities. Fixed income securities provide current income, diversification and a smoothing of overall portfolio returns; they also may serve as an attractive wealth preservation tool. At issue is not so much whether to invest in fixed income securities as opposed to what strategy should be followed that best meets individual objectives while being appropriate for the overall economic and investment environment.

- **Common Risks**—Among the risks associated with fixed income securities, perhaps the most common are changes in interest rates, credit and reinvestment risks.
 - **Interest Rate Risk:** At the risk of stating the obvious, bond prices and interest rates move in opposite directions. As interest rates rise, bond prices fall, and vice versa. Interest rate risk is the risk of experiencing lower bond prices due to rising rates. Given current rate levels, interest rate risk is seemingly higher today than it was throughout the 1980s and 1990s.
 - **Credit Risk:** Credit risk refers to the underlying entities’ ability to pay scheduled principal and interest payments. Backed entities, such as U.S. Treasuries or general obligation municipal bonds, have low credit risk; comparatively, low-grade corporate bonds have higher credit risk.
 - **Reinvestment Risk:** Reinvestment risk is the risk of having to reinvest future principal payments (at maturity) at rates below current levels, a function of falling interest rates.
- **Portfolio Strategies**—Among the most common fixed income strategies are ladder, barbell and bullet strategies.

Exhibit 15

LADDER ILLUSTRATION

Historical Performance of U.S. Treasury Bond Ladder



Source: Bloomberg, Piper Jaffray

- **Bond Ladder:** A ladder portfolio consists of investing in fixed income securities with approximately equal dollar amounts in each maturity over a predetermined number of years. This allows investors to have funds maturing on a regular basis; at maturity—assuming the funds are available for reinvestment—the funds are reinvested at the long end of the ladder. Ladder portfolios provide investors with ongoing liquidity; the strategy removes the analysis of determining the likely direction of rates; and investors receive an

average return over a predetermined number of years. Exhibit 15 presents a graphical illustration of how a ladder portfolio has a smoothing effect on the variability of annual income when compared to three-month or one-year Treasuries.

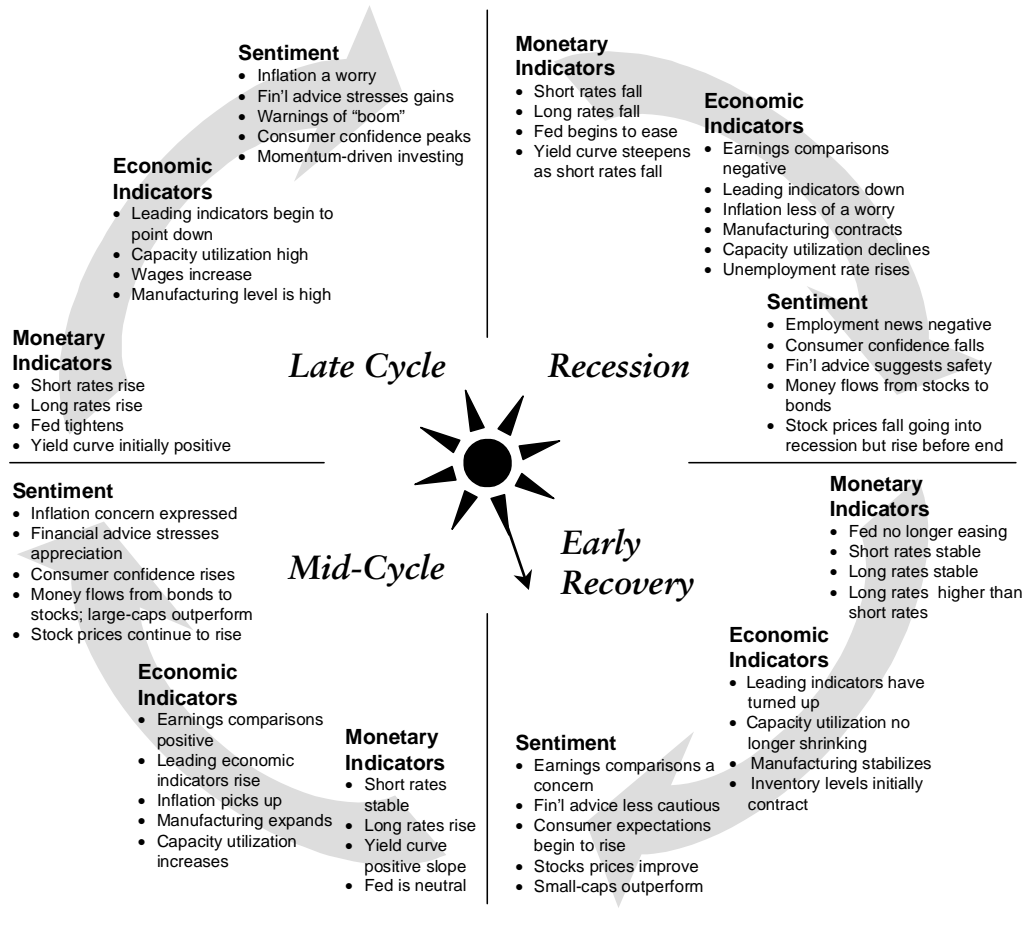
- **Barbell:** A barbell portfolio is where there is considerably greater weights given to the shorter and longer maturity bonds than the intermediate maturity bonds. This strategy is particularly effective in environments where short rates rise faster than long rates. In an increasing rate environment, short maturing bonds can be reinvested at higher rates.
- **Bullet:** A bullet portfolio consists of fixed income securities that are concentrated in the intermediate maturity relative to shorter or longer maturities, or at a future period where certainty of available funds is required.

Step 4: Measuring and Monitoring Results

Measuring, monitoring results and rebalancing are important components of managing portfolios in all environments.

- **Staying On Course**—Regularly measuring and monitoring results is important as this step helps ensure that the portfolio is on track. Among the points for consideration are many of the items listed in Exhibit 2, including the rate of return, risk analysis, and current and historical asset allocation. Changes in market and economic conditions, investor objectives, tax policy, etc., are among the many reasons why rebalancing is an important component of the monitoring process.

ECONOMIC CYCLE



• **Economic Cycle**—The economic cycle is in constant motion. Exhibit 16 reflects monetary indicators, economic indicators and sentiment characteristics of four suggested phases of the economic cycle. They include recession, early recovery, mid-cycle, and late-cycle phases. The characteristics of each phase suggest that the U.S. economy began 2004 in the early recovery, possibly approaching the mid-cycle phase. Knowledge of the current position within the economic cycle has implications for what asset classes are over- or underweighted.

EFFECTS OF TAXATION

Type	Amount	Maximum Tax Rate*	Tax	After-Tax Income
Dividend Income	\$10,000	15%	\$1,500	\$8,500
Interest Income	\$10,000	35%	\$3,500	\$6,500

* 2003 federal rates

Before-Tax And After-Tax Comparisons

Before-Tax Yield Rate	After-Tax Yield	
	Interest*	Dividend**
6.00%	3.90%	5.10%
5.00%	3.25%	4.25%
4.00%	2.60%	3.40%
3.00%	1.95%	2.55%
2.00%	1.30%	1.70%

* 2003 top bracket (35%)

** 2003 top bracket (15%)

Exhibit 18

QUICK TAX FACTS—2003 TAX ACT CHANGES IN CONTEXT 10-YEAR TAX FORECAST

The chart below provides important amounts and percentages for 2002 through 2011. Changes made by the Jobs and Growth Tax Relief Reconciliation Act of 2003 are indicated in the shaded portion of the chart. Additional limitations, inflation adjustments, and transitional rules may apply. See the Explanations in CCH's 2003 Tax Legislation: Law, Explanation and Analysis or 2003 Tax Legislation: Explanation and Analysis for complete discussions of the changes.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
CAPITAL GAINS										
Capital gains rate	20%	15%*	15%	15%	15%	15%	15%	20%	20%	20%
Capital gains rate for taxpayers in 10% or 15% bracket	10%	5%*	5%	5%	5%	5%	0%	10%	10%	10%
DIVIDENDS										
Dividends rate (taxed as capital gains)	Did not apply	15%	15%	15%	15%	15%	15%	Will not apply	Will not apply	Will not apply
Dividends rate for taxpayers in 10% or 15% bracket (taxed as capital gains)	Did not apply	5%	5%	5%	5%	5%	0%	Will not apply	Will not apply	Will not apply
INCOME TAX RATE REDUCTIONS										
Top bracket	38.6%	35%	35%	35%	35%	35%	35%	35%	35%	39.6%
Fifth bracket	35%	33%	33%	33%	33%	33%	33%	33%	33%	36%
Fourth bracket	30%	28%	28%	28%	28%	28%	28%	28%	28%	31%
Third bracket	27%	25%	25%	25%	25%	25%	25%	25%	25%	28%
Second bracket	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Initial bracket	10%	10%	10%	10%	10%	10%	10%	10%	10%	No 10% bracket

*post-5/5/03

Source: CCH Incorporated, 2003

- *Tax Changes*—The \$350 billion federal tax-cut package passed in 2003 serves as a timely illustration of why rebalancing and portfolio reviews are currently in order. As presented in our July edition, note in Exhibit 17 how tax rates affect after-tax income yields and in Exhibit 18 how capital gains, dividends and income tax rates change with this new legislation.
- *Rebalancing*—The process of measuring and monitoring results must be linked to portfolio objectives. This philosophy dictates what is rebalanced. For value-oriented investors, one way of achieving rebalancing is to put future money into the categories that have lagged, thus postponing possible capital gains taxes while bringing the mix back to plan. Another way, as noted, is to shift some funds out of the classes of outperformers and into the underperformers. This may be difficult for some investors as, psychologically, it is easier to put more money into investments that have rewarded us than those that have disappointed us.

Gaining Peace of Mind

Prudent portfolio management involves the allocation of funds among equities, fixed income, international securities, alternative investments and cash based on return expectations for a given level of risk and the portfolio's objectives.

- We encourage investors to become familiar with the issues and events influencing the changing financial landscape.
- We challenge investors to take a critical look at their current investment portfolios, assessing whether current holdings are consistent with portfolio objectives.
- We recommend that investors take action and gain peace of mind by implementing an investment strategy that is consistent with portfolio goals and objectives and that is flexible to adjust to the changing financial landscape.

Important Research Disclosures

Analyst Certification

—Terry D. Sandven, Director, Private Client Research

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