

QUARTERLY
COMMENTARY

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

10 LARGEST HOLDINGS AS OF
SEPTEMBER 30, 2005

Large Cap Equity:

Motorola Inc. (MOT)
Aflac Inc. (AFL)
McDonalds Corp. (MCD)
CVS Corp. (CVS)
US Bancorp (USB)
Time Warner Inc. (TWX)
Microsoft Corp. (MSFT)
Bellsouth Corp. (BLS)
Citigroup Inc. (C)
Abbott Labs (ABT)

Mid Cap Equity:

Bear Stearns Cos., Inc. (BSC)
Fiserv Inc. (FISV)
E*Trade Group Inc. (ET)
BJ SVCS Co. (BJS)
Mercury General (MCY)
Staples Inc. (SPLS)
Liz Claiborne Inc. (LIZ)
Health Management Associates (HMA)
Constellation Energy Group Ltd. (CEG)
Reebok International Ltd. (RBK)

RORER
ASSET MANAGEMENT, LLC

THE RORER REVIEW

HIGHER PRICES AHEAD!

In the last issue of the Rorer Review, entitled *Slower is Better*, we stated our belief that the U.S. economy, while still relatively strong, was likely to enter a period of reduced growth in late 2005 and into 2006 thanks to the twin forces of rising interest rates and higher oil prices. We further opined that this scenario would prove favorable for the equity markets since such a scenario would likely be accompanied by the end of the Fed's tightening cycle. Once the Fed stops raising rates, investors typically anticipate renewed economic growth in the future and act accordingly.

During the third quarter, however, the rising trend in oil and interest rates continued. Oil prices spiked mostly due to hurricanes Katrina and Rita. The devastation in Louisiana, Mississippi, Texas and the entire gulf coast has been well documented. For some neighborhoods and cities in these areas full recovery is years away. This region of our country is also home to many of our oil wells and refiners, several of which were damaged or closed down during and after the storms. The result was a surge in oil and natural gas prices. While oil has backed off its highs, it still sells for roughly \$65 per barrel. Natural gas, which some are predicting a shortage of this winter, has actually risen in price almost 150% in the past 12 months!

The obvious result of this is much higher energy costs for consumers and business. The most immediate impact came in the form of gasoline prices that shot well above \$3.00 per gallon. Consumers, who until that time had not let the rising price of gasoline affect their driving habits, quickly eased up on the gas pedal and demand for gasoline dropped 9%. A further shock will come this winter when it's time to pay home heating

costs. Monthly charges for the 60% of us that use natural gas to keep our homes warm could easily rise 25% to 30% or more! While we expect the price of oil and natural gas to ease off of these high levels over the next several months, there probably won't be much near term relief for the consumer.

All of this has not caused the Alan Greenspan-led Federal Reserve to veer from its course. The Fed has actually raised the Fed Funds rate twice since our last report. It now stands at 3.75%, with the second increase coming after hurricane Katrina wrought its devastation. Many investors and economists had speculated that accompanying the latest 25 basis point increase the Fed might give some signal that the end of the tightening cycle was in sight. When the Fed failed to indicate any change in policy would be forthcoming, the equity markets were disappointed and came under subsequent pressure. At this juncture, most market prognosticators believe that the Fed is poised to continue tightening for some time.

We had predicted that the Fed would end its tightening cycle well before now, based on our assumption that economic growth would be slower than it has been. The main problem with our thesis has been the unexpected longevity of the current housing cycle. While there have been some recent signs of cooling in housing, year-to-date housing prices are up an average of 16%. Further, the homebuilders seem to think the market strength will continue. Lennar, which builds homes in several states throughout the U.S., recently announced earnings well above analysts' expectations and predicted a continued robust housing environment.

This has not been lost on the Fed. Alan Greenspan is very concerned with the prolonged strength of the housing market and is particularly troubled by the risky nature of some of the mortgage instruments being issued today. He has spoken several times of these concerns, publicly stating his apprehension over the increasing use of IOs, or Interest Only mortgages. IOs are mortgages that require borrowers to make only interest payments on their loans, typically ending with a large principal, or "balloon," payment at the term of the loan. Because the borrower is not reducing the principal balance of his loan during its life, any subsequent weakness in the housing market can result in a loan that is greater than the value of the home. This can lead to a potentially devastating financial condition for the homeowner when it comes time to sell his house. We believe that Mr. Greenspan, as he did with his "irrational exuberance" comments at the height of the technology bubble, will continue to raise interest rates and voice his concerns until he is satisfied that these risks are under control. Given the dual forces of dramatically higher energy prices and the rising cost of borrowing, we believe this inflection point in the interest rate cycle will occur during the fourth quarter of 2005.

All of this is bad news for the consumer. Americans have had a voracious appetite for all kinds of goods for the past several years. This has been a boon to retailers and companies that produce consumer goods. Additionally, our demand for imported products has generated a large and growing U.S. trade deficit. A great deal of this demand has been fueled, however, by rising home prices which enabled consumers to cash in their home equity to pay for these goods. When the housing market does begin to cool off, we think the consumer is likely to retrench. Add to this mix the higher gasoline and home heating costs and we could have the makings of a fairly anemic consumer sector for some time to come.

While there will be opportunities in the consumer stocks as we move forward, we believe only the most nimble and well positioned companies will drive incremental growth.

THE MARKETS

We have felt for some time that the tougher economic environment that we foresee will result in the out performance of large capitalization stocks. However, thus far in 2005, the large capitalization-biased S&P 500 continued to lag behind that of the S&P 400 Mid Cap index and the Small Cap S&P 600. Given the headwinds of higher interest rates and rising energy costs, we see this trend reversing in the near term. In fact, we find it intriguing that some well-known investors and hedge funds see enough value in large cap stocks like Time Warner and McDonalds to build outsized positions in an attempt to force these companies to unlock value. These are but two examples of the many attractive values in the large cap universe, and indeed in the Rorer Portfolio, today.

We believe the upcoming third quarter earnings reporting season will potentially be hazardous. Higher raw material costs, hurricane related expenses, and a strengthening dollar will combine to take their toll on companies' bottom lines. We believe the near term outlook will be particularly tough for smaller companies that cannot offset some of these pressures through diversification either across business lines or geographically.

However, we are optimistic about the direction of the market and our investment opportunities. We believe the market, having traded basically sideways for the better part of the past two years, is already anticipating much of this news. Many cyclical issues, especially, are well below recent peaks. Moreover, many high quality, financially sound companies are trading at historically compelling valuations. What has been missing from this equation, in our opinion, is the catalyst to get the mar-

ket moving in an upward direction. We believe we will get that catalyst, in the form of the end of the Fed's tightening program, in the not too distant future. There are higher prices ahead!

At Rorer Asset Management each investment decision is made on the merits of the individual stock being purchased or sold. On a macro level, however, our expectations for a slowing economy and a peaking of the interest rate cycle have led us to emphasize stocks of companies with more stable earnings. We have been overweight healthcare all year and more recently, the telecom sector. In more cyclical issues, such as finance and technology, we have built positions only when valuations were particularly compelling or a catalyst was in place to offset economic concerns. This strategy has served us well in our Large Cap portfolio thus far in 2005 generating out performance in each quarter, despite the continued under performance of the large cap sector of the market.

The under performance of the large cap universe has lasted for the better part of six years. These stocks, which form the basis of the Rorer universe, are expected to out perform as we travel through the slower growth economy we envision going into 2006. Balance sheets are strong. Historically high cash levels provide large US companies with several options for generating meaningful dividend increases and earnings growth. Opportunities to fund internal investment, acquisitions and significant share repurchase programs abound. Rorer's philosophy of purchasing large, high quality stocks trading at a discount to historical relative valuation levels ideally positions us to generate solid investment returns for our clients over the coming quarters and for the long term.

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