Lucien, Stirling & Gray Advisory Group, Inc.

# THIRD QUARTER REPORT 2004

October 2004

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## A MESSSAGE FROM THE PRESIDENT

*Thomas G. Twombly*

We are pleased to provide you with our quarterly report for the period ending September 30, 2004.

We would like to take this opportunity to review some of the major developments in the investment profession as a whole during the last twelve months, and to highlight some of the more significant improvements we have implemented at Lucien, Stirling & Gray in our efforts to serve you better.

A year ago, as we prepared our report for the third quarter of 2003, the financial profession and the general public were just beginning to face up to a growing scandal in the mutual fund industry. Several prominent investment firms had been implicated in investigations into allegations of late trading, market timing, and self dealing, and there was a great deal of concern that confidence in the entire profession would be damaged irreparably, and that both individual and institutional investors would rapidly withdraw assets from financial markets, creating a self-fulfilling downward spiral.

In our report we took the opposite view, and stated our opinion that ultimately the scandals, though painful, would result in an increased focus on integrity in the profession, a weeding-out of less than trustworthy individuals, and a far more healthy long-term business environment. We are pleased to see that the preponderance of evidence now supports this view.

In the last year we have witnessed substantial penalties being imposed upon firms that violated their client's trust, both by regulators and by the investing public. A number of executives have been barred from the profession permanently, huge fines have been levied, and most importantly, investors have "voted with their feet." In fact, according to a recent report on NPR, investment companies that remained free of allegations of wrongdoing have actually experienced a collective growth in assets of more than 22% during this time – a truly impressive number. At the same time, the 21 firms implicated in relatively "minor" violations have experienced a collective increase of only 2%, and the four worst violators have seen total assets decline a massive 10 – 25%. Clearly, a strong message has been sent that malfeasance will not be tolerated, and billions of dollars have been re-allocated to firms that hold client trust as paramount. We view this as a very positive development, and a welcome indicator of important long-term change.

***"Clearly , a strong message has been sent that malfeasance with not be tolerated,..."***

At Lucien, Stirling & Gray, we are pleased to be able to report that our efforts on behalf of our clients have been rewarded, and our business has grown steadily. We have been privileged to be referred to a growing number of new clients, and during the past twelve months we have seen our asset base increase by almost 19%. We want to offer our sincere thanks for the confidence and trust that you have shown in us, and for the referrals you have made to us. We promise to do everything in our power to maintain and build upon that trust.

In August of this year, we were joined by a new associate; Bleckley Dobbs. Bleckley came to us after a 20-year career as an engineer with 3M Company, and after completing a rigorous course of study in which he earned a Certificate in Financial Planning from The University of Texas. He brings new strengths and camaraderie to our team, and we are very pleased to have him aboard. If you would like to learn more about him, or about other members of our team, we encourage you to visit our website at www.lsggroup.com.

On September 1st of this year, J.P. O'Sullivan was promoted to the position of Vice President and Chairman of our Investment Policy Committee. J.P. is now in his fifth year with the firm, and has proven himself as an invaluable asset to our operations. His careful attention to detail, and his steady focus on providing our asset management team with solid, risk-conscious portfolio design has added significant benefit to our firm, and to our clients in the last four years. We hope you will join us in welcoming him to the executive team.

As we enter the final months of this year, and as we look forward to 2005, we continue to look for ways to improve upon our professional services. Among other things, we are currently examining potential changes to our fee structure that would better reflect the total services we offer. As always, we welcome any insight or advice you would like to share.

Thank you again for the confidence you have shown in us. We look forward to a prosperous future together.

Thomas G. Twombly
President

## CORE MODEL COMMENTS

**Conservative Growth Model**: Currently, this model is allocated with over 48% in US equities, 10% in foreign equities, 20% in fixed income, and the remainder in cash equivalents. These last two classes helped dampen much of the loss the model's equity positions experienced at the start of the quarter and continued to perform well even as equities rebounded in the second half of the quarter.

The model is currently underweighting small cap and growth positions due to the more attractive investment options we have identified in the mid cap and value arenas. For the past quarter, the model's return was essentially flat but year to date the model has posted a positive return of 3.21% and 10.49% over the last year.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| (.06)% | 3.21% | 10.49% | 33.23% |

Inception Date 06/03/1999

**Core Growth Model**: During this most recent quarter, this model shifted assets from middle and small capitalization growth oriented companies into fixed income and cash. This left the model with 41% in US equities, 20% in foreign equities, and 20% in fixed income, with the remainder in cash equivalents. With regard to capitalization, the model is now overweight middle and large capitalization companies with an almost even split between growth and value companies.

It is likely the committee will begin reducing the model's cash allocation during the fourth quarter if appropriate opportunities present themselves. Although the model had a strong September, up almost three percent, the model finished down a little over two percent for the quarter. Year to date the model is up 3.88% and for the last twelve months, the model has gained 11.33%.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| (2.27)% | 3.88% | 11.33% | 16.63% |

Inception Date 05/31/2003

**Growth Model**: There was an allocation shift in this model during the past quarter. The committee moved assets from small and middle capitalization growth companies into large capitalization growth companies. The committee also reallocated the fixed income portion for the model from convertible securities to more general fixed income.

As of September 30th, the model had 48% in US equities, 22% in foreign equity, and 15% in fixed income with the remainder in cash equivalent instruments. For the third quarter, the model ended down 2.95% but is up almost 2% year to date and for the last twelve months, the model has an impressive gain of 14.76%.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| **(2.95)%** | **1.91%** | **14.76%** | **532.40%** |

Inception Date 10/16/1992

## SPECIALITY MODEL COMMENTS

**Diversified Growth Model**: This 100% equity model comprised of ten style boxes made a single allocation change during the quarter. The model moved assets from the small growth arena where gains had caused the model to become overweighed and into the underweight arena of large value. This move returned the model to a more neutral stance, where large capitalization companies are now only slightly under weight when compared to small capitalization companies.

This balanced approach is also represented in the style arena where value and growth are almost in balance. Like much of the equity universe, the model was unable to pull into positive territory before the end of the quarter even after posting a September return of almost four percent and ended the third quarter down 3.34%. Year to date the model is up 4.56% and over the last 12 months the model had a return of 16.88%.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| **(3.34)%** | **4.56%** | **16.88%** | **11.67%** |

Inception Date 10/31/2000

**Aggressive Growth Model**: There was only one change made in this model during the third quarter. This was the committee-approved reduction of one position in order to dampen the model's volatility and reduce the overall allocation to foreign equity. This left the model with an allocation of 39% in US equities, 38% in foreign equities, and the remainder in cash equivalent instruments.

The model continues to heavily overweigh small capitalization companies and growth over value. Even with a greater than six percent return in September, the model was unable to get back in to the positive column and finished the quarter down a little over two percent. Year to date the model is down 6.44% but remains positive for the last twelve months up 3.6%.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| **(2.04)%** | **(6.44)%** | **3.60%** | **39.70%** |

Inception Date 09/08/1998

## EDUCATION MODEL COMMENTS

**UT ORP:** At present, 52% of this portfolio is allocated to US equity, while 16% is invested in foreign equities. The remaining 32% is divided among fixed income, convertible securities, and cash equivalents. The portfolio is heavily weighed toward large capitalization companies due to both the available plan options and the quality of the management they provide; however, during the quarter, the model benefited most from its new small cap value position and the model's foreign equity exposure. Even with the strong performance of these two categories, the model finished the quarter down 2.31% but remained positive for the year to date and over the last 12 months was up 11.30%.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| **(2.31)%** | **.63%** | **11.30%** | **11.97%** |

Inception Date 08/10/1999

**Retirement Growth**: This portfolio continued to benefit from its over weighting of foreign equity. At the end of the third quarter, the portfolio was 36% in US equities, 32% in foreign equities, and the remaining portion of the model allocated between fixed income, convertible securities, and cash equivalents. This has proven a stable allocation even during a rather rocky quarter.

The portfolio did finish in the red but by less then a half a percent and year to date the model is still up over 5% and up 17.59% for the last 12 months.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| **(.20)%** | **5.03%** | **17.59%** | **30.71%** |

Inception Date 06/03/1999

**Growth and Capital Preservation**: In this conservative model where volatility is a primary consideration, the model finished the quarter with fixed income, convertible securities, and cash equivalents representing 51% of the model, while US equity represented a little over 41% and the remainder was allocated to foreign equity. This allocation allowed the model to avoid any serious loss during the quarter and it remains up over 2.5% for the year and 11.62% for the last 12 months.

| 3rd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| **(.43)%** | **2.55%** | **11.62%** | **16.25%** |

Inception Date 11/30/2001

Lucien, Stirling and Gray
Investment Policy Commitee

**Upcoming Events**

**Fireside Chats:**

***"Reflection on Maintaining Wealth through the Generations"***

Speaker: Mark Ward

Decmber 2, 2004
**6:30 pm - 8:00 pm**

**General Market Results**

| | *Quarter* | *YTD* | *One Year* |
|---|---|---|---|
| ***CPI*** | (.11)% | 2.81% | 2.32% |
| ***DJI*** | (2.90)% | (2.12)% | 11.00% |
| ***NASDAQ*** | (7.36)% | (5.31)% | 6.16% |
| ***S&P 500*** | (1.87)% | 1.50% | 13.86% |
| ***Russell 2000*** | (2.85)% | 3.71% | 18.77% |
| ***MSCI World ex US*** | .25% | 4.90% | 22.77% |
| ***LB AGG Bond*** | 3.20% | 3.35% | 3.68% |

Lucien, Stirling & Gray Advisory Group, Inc. is a Registered Investment Advisory firm providing fee-based asset management and planning services to individuals, corporations, trusts and foundations.

*For more information about our firm, please visit our website at www.lsggroup.com ●Model holdings may change due to ongoing management ●Sector and style breakdown is constructed with the best available information and therefore is only as accurate as the available information ●Past performance in no guarantee of future results ●It is impossible to invest directly in indices ●Percentages may not equal 100 due to rounding*

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