Weinstat & Weinstat
INVESTMENT ADVISORS & CPA'S

Weinstat & Weinstat Investment Advisors & CPA's
516-621-3507 | info@weinstatandweinstat.com

October 3, 2005

Greetings,

Enclosed is your investment report through 09/30/05. The absolute return is discouraging to say the least. I anticipate that our investment returns will improve before I run out of negative adjectives to describe our absolute performance. The stock market continues to do lousy. The S&P 500 is flat for the year. This is misleading. If you take the returns of the white hot, momentum driven energy sector out of the S&P 500, then the broad markets return is down 2%. The Dow and Nasdaq are also down 2% YTD.

Because of the drop in the market (among other reasons), I consider this to be the best buying opportunity I have seen in three years. Actions speak louder than words. Unlike most people in my profession, I don't simply make recommendations, I practice what I preach. I recently sent a significant amount of my own cash to my Brown & Co. account which added to the cash that was already there. The recent news headlines caused the market to have its worst week in several months. I took this as an opportunity to purchase some great companies at reasonable prices. I added to two of my holdings, Toll Brothers and Las Vegas Sands in addition to taking several new positions. I will be staying at Wynn resorts this week while doing some hands on research, which is also something that others in my field don't do. I expect to add to my position in Wynn resorts upon my return. I did see Wynn resorts in person in May but did not stay there.

I thought you might be curious as to my recent financial activities. Now on to more topical things:
If this market were behaving in any way that resembled rationality, we would be doing considerably better. I find it important to know the reasons why things are the way they are. In addition to the continuing rise in the price of the black stuff that everyone discusses virtually every hour on the hour (some more on that later), the market is in a situation somewhat similar to what happened in 1999 and early 2000. There is a finite amount of capital to invest. Six years ago, most of that capital chased technology and internet stocks. We know the result of that. Now, most of the money is chasing real estate and energy stocks. When a significant amount of capital chases just two types of investments, then there isn't much left over to purchase the quality companies that we own at reasonable prices or the companies that our mutual funds own.

I haven't gone into what has been happening in the real estate market in previous letters mostly because we don't own it and because there are more relevant things to address than what others are making (or losing) money in. Until very recently, there had been much talk, some might call it speculation, that the real estate market would continue to go straight up. That talk was very similar to what I used to hear about the technology sector not that long ago. I am not attempting to compare the two markets. What is similar is the outlook of the investors now versus then, not the markets themselves. I find it interesting that, other than people who were always in the real estate market, very few people were interested in purchasing second homes or real estate partnerships for investments purposes six years ago. Now, 30% of second home purchases are for investment purchases. I don't have the exact figures but a significant amount of new homes are being sold even before they are completed. Over the last several years, the real estate market hasn't been going up because there is, a shortage of places to live. There is a limited amount of land for new homes. While the supply of housing is limited, it is no less limited than is was five or fifteen years ago when home prices were in a decline. There hasn't been a sudden boom in population resulting in people who want to purchase real estate. Incomes (other than the wealthiest 1% of the population) have increased modestly over the past five years so people aren't exactly flush with cash.

The only reason for the real estate boom was the dramatic drop in mortgage rates. Since the majority of home owners make their purchases with debt, it is logical for the prices to go up as financing costs decline. What is alarming is what has continued to fuel the run up since mortgage rates have stopped declining this year. I am still a CPA. When I used to do more accounting work, I would get uneasy when occasionally a client would suggest that "I get creative ". Well lo and behold, the mortgage lenders this year are getting creative. At first, I started reading about interest only mortgages. I wasn't thrilled about this since I am debt averse. When I purchased my co-op back in 1990, I made a down payment of 40% of the purchase price. The interest rate back then was 9 3/8%. I suppose if I could have gotten a rate of 5 ½%, I would have put down 20% which was the norm back then. 99% of the country lives on credit. An interest only mortgage at a fixed rate of 5 ½% on a house is not the worst thing in the world. Then I read some more. What I found out is that to make the houses more affordable, 40% of the new mortgages have been adjustable rate, not fixed. I find that a little disturbing but not too alarming. It is a bit of a risk but if rates don't go up significantly, it won't be a big deal.

Now, I read some more articles about lending practices to make houses even more affordable. If you have a weak stomach, I suggest that you skip this paragraph and move onto the next one. There is a new type of mortgage available called optional ARM's. These are adjustable rate mortgages that are interest only and you have the option of paying less than interest only each month. That means that each month you can choose to make your payment at less than interest only. Instead of increasing the equity in your house and paying down the mortgage, or at least keeping the debt the same, you are incurring more debt because the unpaid interest gets added on to the debt. When I first heard about this, I thought to myself it sounded like something that Tony Soprano (of the HBO series the Soprano's) or some real life Mafia person thought up. I am not joking with this. What is even more alarming is according to Countrywide Financial (the leading mortgage originator), 20% of new mortgages are these optional ARM's. If some of these people need to move for job related reasons and the price of their house is close to what they paid for it, they could be in real trouble because the debt will be higher than the value of the house.

I expect that I gave you some food for thought. Mortgage rates aren't going any lower and personal incomes aren't going up by that much. All you have to do is see the logic and do the math to see why the returns going forward in real estate won't be close to what they were in the recent past.

The scary part is over so if you skipped the previous two paragraphs, welcome back. There has been quite a bit of jawboning recently about a real estate bubble and a possible crash. I find it interesting how so many people feel that the real estate market will either go straight up or crash. I am in neither camp. The national real estate market is not in a bubble and is in no danger of crashing. Certain parts of the country are way overpriced and are in danger of a significant price decline. A price decline in a few parts of the country will not impact the national real estate market. As long as mortgage rates stay low, that will provide a support to the national real estate market. I think the worst case scenario would be for mortgage rates to go up to the 6 ½%-7% range. If this happens, the real estate market will either flatten out or fall slightly. It won't crash since a 7% mortgage while higher than it is now, is still a good rate. When I refinanced my mortgage back in 1993, I was thrilled to get a rate of 6 ¾%. More realistically, I think that mortgage rates will rise slightly and the real estate market will go up by about the same rate as personal incomes rise.

The energy sector is the only sector of the S&P500 that is up significantly this year. With only one sector up, I think you can see why we aren't making any money. The

Saudi Arabia oil minister himself said that based on supply and demand, the price of the black stuff should be in the mid 40's, not $ 66 a barrel where it is now. A columnist in today's Wall Street Journal wrote the same thing. He echoed my views that the price of the black stuff is going up based purely on speculation. That doesn't mean that the price of the black stuff that everyone is obsessed about will suddenly drop. Many intelligent people knew the technology sector was in a bubble in early 1999 but it didn't burst until a year later. I do not know exactly when the energy sector will burst. When only one sector goes up (without the sustainability of earnings) when logically other sectors that are more fundamentally sound should also be, it is only a matter of time before it happens. My gut feeling is that it will happen sooner rather than later. When it does happen, those who have committed their money at this point in time will have significant losses.

The Federal reserve once again raised short term interest rates despite two devastating hurricanes. The Federal reserve is more concerned with rising inflation than the potential of slowing down this economy to near recessionary levels like they did 5 years ago. We all make mistakes. Most intelligent people learn from them and don't repeat them. Apparently, the Fed. does not learn from its mistakes. It also raised rates too high in 1994.

With the continuing rise in energy prices, inflation has increased to an annual rate of 3.6%. This is the highest rate of inflation in 4 years. We have gone from a period of near zero inflation to low inflation to what is now a normal inflation rate of the last 10 years. Inflation at this rate is not a problem. If it continues to rise and stays high, then it will be a problem.

Corporate earnings last quarter were excellent, as they have been. The main reason why I am optimistic about the stock market is because corporate earnings have been strong and are expected to be in the near future. It only makes sense that if stock prices fall while at the same time earnings rise at a healthy rate, then it's an opportunity to put new money to work. It is also very encouraging that there have been virtually no negative major earnings pre announcements during the last couple of weeks. You would think that with two huge hurricanes, dozens of companies would have forecasted poor earnings for the third quarter. This has not been the case. I am sure that some companies will have less than expected fourth quarter earnings as a result of the hurricanes. I think that many of those companies that fall short in the fourth quarter will more than make up for it next year. My feeling is the same for the market in case the year end rally is muted.

I believe that I gave you quite a bit of information to chew on. If you have any questions, I would be happy to discuss them with you when I return after October 10.