

BRADY INVESTMENT COUNSEL LLC

INVESTMENT REVIEW

ANNUAL REPORT FOR THE PERIOD ENDING
MARCH 31, 2005

QUARTER ONE 2005

(Note: We will now be reporting on a calendar end as opposed to a fiscal year March 31 basis.)

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INVESTMENT REVIEW

QUARTERLY REPORT FOR PERIOD ENDING MARCH 31, 2005

TO OUR CLIENTS AND INTERESTED INVESTORS

SUMMARY

The market environment was challenging in 2005's first quarter. The S&P 500 Equity Index was down 2.2%, the S&P/Barra Growth Index was down 1.9% and the Russell 1000 Growth Index was down 4%. As indicated in our 2004 annual review, we felt the late-in-the-year rally – the market was up 9.2% during the fourth quarter - was more indicative of a top in small cap stocks and borrowed from 2005 total return potential. Market activity substantiates this as small cap stocks were down 5.3% in the first quarter of 2005 yet still trade at a premium to large caps, the size on which has not been seen in 25 years.

The bond and equity markets are currently at odds. The equity market is discounting higher inflation and interest rates. The bond market simply is not. At 16X forward earnings we estimate the stock market is discounting a 10-year Note rate of between 5.5% and 6.0%. That is a significant increase from the current 10-year Treasury rate of 4.4%.

We think the bond market is right this time. The stock market is too focused on non-secular things such as the current high price of oil and its impact on general price levels as well as interest rates. However, the real key to predicting inflation and higher interest rates is to understand the relation between wage growth and changes in worker productivity. If wages grow faster, the net result is an economy with too many dollars chasing too few goods. This situation, if it is sustained, leads to higher prices.

The first quarter's mini-correction combined with our view that a good economy will drive respectable profit growth, causes our market outlook for the rest of the year to become more positive. The S&P 500 is attractively priced at 16X estimated 2005 earnings and is yielding 2%. We see upside in the 7%-10% range by year end and are finding our best ideas in the large cap, quality growth sector.

Finally, we are not dismissing the high price of oil and its impact on the economy. It is an area of concern, at least for the short term. If the price of gasoline stays the current \$2.30 per gallon, consumers will spend an additional \$5 billion per month to fill up their cars this summer. To put this in perspective, the U.S. is roughly a \$12 trillion economy with consumers accounting for two-thirds, or \$8 trillion in annual spending. This equates to \$667 billion in spending per month. Therefore, the expected increase in the amount spent on gas represents three-quarters of one percent of all monthly consumer spending. While that may not sound like a large percentage, the increased gas spending will negatively impact other areas of consumer spending. Typically consumer discretionary spending takes the hit so look for less to be spent on things like vacations, dining out and clothing in the

months ahead. Rising gas prices can also lead to **temporary** spikes in inflation, which may lead to higher interest rates, lower P/E multiples and increased market volatility over the short term. Positively, volatility typically leads to opportunity and this summer we will be looking for company's with solid long-term fundamentals who's shares may be depressed by these temporary factors.

INVESTMENT REVIEW, FORECAST AND TRADING

CORE GROWTH STRATEGY

The Brady Investment Counsel LLC Core Growth Investment Strategy model was down slightly during the quarter, -0.1% after fees. Stocks that helped performance included hospital operator HCA Inc (HCA-up 34%) and restaurant retailer Panera Bread (PNRA-up 40%). Both positions are long-term holdings and have been in the portfolio for over two years. Calpine (CPN-down 29%) was the quarter's big loser. CPN is a long-time holding as well. It is also proof that the adage often cited by money managers; "The position is too small to hurt performance", is false. Our investment in these shares remains under evaluation.

We began the quarter with nearly 9.0% of model portfolio assets in cash. All of that was put to work during our first of four buy/sell programs we typically put in place during the year. New positions included technology company Hewlett-Packard (HPQ), agricultural, commodity producer Archer-Daniels-Midland (ADM) and Defense contractor L-3 Communications (LLL). No positions were sold

FOCUS STRATEGY

Our Focus Strategy was up 0.1% after management fees. Performance was helped by our investments in HCA and HPQ. HPQ performed particularly well near the quarter's end. On March 29, the company announced a new CEO and the shares were up 10% from that point on. First Data (FDC – down 7.5%) hurt performance. Although their business is fundamentally strong, the market for technology shares was weak and FDC shares were down in line with the rest of information technology sector.

New positions added during the quarter included HPQ and biotechnology company Biogen (BIIB-\$34.51). We added a partial position to BIIB after the shares dropped 43% in a single day. The big drop was the result of disappointing news surrounding a product for which the market had high hopes. We will wait until after the company reports March quarter earnings and discusses its long-term growth outlook before deciding whether or to increase this investment to a full position. The Focus Strategy's cash percentage is high, 16% versus 25% at year end. We will put cash to work during our second quarter buy/sell program, after companies have reported their operating results.

EXCHANGE TRADED FUND (ETF) STRATEGY

Finally, our ETF Strategy was down 2.0% after fees. This was 20 basis points better than the general market. Our heavy weighting in the Large Cap Growth ETF (IVW) helped. These shares, which mimic the performance of the S&P 500 Barra/Growth Index, were down 1.7% in the March quarter. Our Index Strategy weights remain unchanged at 50% S&P 500 Equity Index (IVV) and 50% S&P 500 Barra/Growth Index (IVW).