



VIEW FROM VISTA

July 11, 2005

Dear Valued Client,

Enclosed is your Quarterly Report from Vista Capital Partners for the second quarter of 2005. After a slow start to the year, both the stock and bond markets began to show signs of life as the second quarter saw the average diversified U.S. stock fund gain 2.3%. Despite the gains, most major stock indices remain down for the year. The average U.S. taxable bond fund edged up 2.1% during the quarter, even as the Federal Reserve twice raised short-term interest rates twice. Real estate was again a great place to be, with funds in that sector gaining 13% on average. U.S. investors saw their international investments fall in value due to the dollar's continued strength. Consider:

- The benchmark 10-year Treasury yield fell from 4.50% to 3.92% over the quarter. *Much to the dismay of many bond fund managers who've been waiting for the general level of interest rates to rise, long-term rates are actually lower than they were when the Fed first began raising rates in March 2004. Just goes to show how wrong the "experts" can be.*
- The S&P 500 now trades at about 16 times analysts' expectations for this year's earnings, down from about 19 times at the beginning of the year. *This decline in valuations will benefit long-term investors since cheaper is better.*
- The average real estate investment trust (REIT) P/E ratio rose to over 19 times next year's earnings during the quarter. When compared with the S&P 500's P/E multiple of 16, this represents the largest premium to the broad market ever. *Probably a good time to start trimming back any bloated REIT positions.*
- Even as China's economy has grown more than 50% over the past four years, its national stock exchanges have lost more than 1/3 of their value. *Despite the boom, equity investing in China hasn't been as profitable as the media would have you believe.*
- Since the start of 2001, investors have put a net \$227 billion into value funds while pulling \$21 billion out of growth funds. *This gap between value and growth investing is in stark contrast to the late 1990's when investors flocked to growth, leaving value stocks in the dust. Typical investor behavior – chasing the hot asset class.*
- Total household debt as a percentage of assets is near an all-time high. Americans are now more leveraged than ever before. *A tough trick considering how rising home prices have increased total household assets.*
- Cash inflows into hedge funds look to slow considerably over the next year, according to the Institute for Private Investors. The reason? Diminishing returns. Over the past five years, the average global hedge fund has returned 8.2% per year, below the 9.6% return of the average global bond fund. *Probably not quite the "bang" investors thought they'd be getting - more reason to believe the only perfect hedge is in a boxwood garden.*

Investment Focus

Vista is excited to have recently gained access to DFA funds. DFA (Dimensional Fund Advisors) offers a unique line-up of index and enhanced index funds which follow strategies based on rigorous academic research. The body of empirical evidence underlying DFA's investment philosophy is compelling. The company roster of prominent Ph.D.s, including two Nobel Laureates, is equally impressive. DFA's results, however, speak loudest as their funds consistently rank among the top performers in their respective categories.

DFA distinguishes itself from other passive (index) managers by constructing their own benchmark indices. This enables them to engineer index funds with smaller average market capitalization and stronger value traits than their peers. Studies reveal that long-term historical returns for small caps and value stocks have been higher than large caps and growth stocks, respectively. Intuitively, this makes sense when you consider they are riskier assets and, therefore, should offer higher potential returns. These size and value effects are evident in both domestic and international markets.

Trading methods also set DFA apart from the index crowd. DFA will allow a fund to stray from the index it tracks rather than trade at unfavorable prices. Most index funds trade regardless of price to maintain complete replication of the index. In the relatively illiquid small cap market, DFA is a large presence and enjoys considerable negotiating power when anxious sellers have large blocks of stock to move. Focusing on price execution is fundamental to their strategy.

DFA funds can only be purchased by institutional investors and advisors who have attended a mandatory conference and received approval to invest. DFA's stable of leading academic minds, sound investment philosophy, low expenses, and impressive performance make their funds appealing additions to our clients' asset allocations. We look forward to incorporating DFA funds into portfolios as appropriate.

Private Wealth Management

Call us naive, but we thought the collapse of the tech bubble in the late-90's taught investors the difference between investing and speculating. Well, were we ever wrong! It's as if investors got tired of the stock market and started looking elsewhere to lose money – real estate.

The telltale warning signs are mounting. First, consider the simple fact that everyone is talking about real estate. It is the hot topic at cocktail parties, on cable TV shows and in newspaper articles, and has graced magazine covers. It is almost hard to hear yourself think over the din of real estate chatter. Then there's another telltale sign of a bubble – a prolonged period of price appreciation that makes it seem perfectly natural and inevitable that prices will only continue to rise. Believing the game has only winners, more and more "investors" jump on the bandwagon.

Then you have the cold, hard facts: the first quarter of this year saw the market value of residential real estate rise for a record 40th consecutive quarter, the gap between house prices and household income is now at an all-time high, the percentage of second home buyers buying for investment purposes increased from 20% in 1999 to 64% in 2004, riskier interest-only and adjustable-rate mortgages accounted for nearly two-thirds of mortgage originations in the second half of last year and, finally, there are the charts showing home values, adjusted for inflation, climbing a wall over the last ten years (eerily similar to stock price-to-earnings ratios in the late-90's).

Buyers' use of extreme leverage is particularly worrisome. If an investor buys a home or property and puts 10% down and borrows the rest, it only takes a 10% drop in price to wipe out their entire investment. Can you imagine if they let you buy \$500,000 worth of Intel for \$50,000? All it would take is for Intel to drop from \$27 to \$24 to lose all of your money. Scariest yet, when leverage is employed, you can easily lose more money than you invested.

The point to all of this is simple; caution is warranted. It might be hard to believe, but real estate prices actually can go down. Los Angeles-area home prices fell over 40% in real terms between 1989 and 1997. Rising interest rates, a slowing economy or prices simply crashing under their own weight could all potentially rain on real estate's parade. And many investors seem to have forgotten the heavy toll transaction and maintenance costs can take on your returns in a more normal market. While we have always believed real estate deserves to play an important role in a diversified portfolio, now is clearly not the time to start building a real estate empire.

Other

We are pleased to announce the launch of our new website www.vistacp.com. We hope you will find it useful for such things as past quarterly letters, topics of interest or just a general review of our business and investment philosophy.

Below you will see a table of year-to-date 2005 returns for most of the major asset classes. As always, we welcome your calls and e-mails and look forward to our next account review or conversation. Thank you for your referrals and for being a client.

Sincerely yours,

Vista Capital Partners

Comparative Returns:

Index	2005 Returns	Description
S&P 500	-1.70%	<i>Large Cap Stocks. 500 of the largest U.S. companies in all sectors of the economy.</i>
Russell 2000	-1.83%	<i>Small Cap Stocks. A broadly diversified index consisting of about 2000 small companies.</i>
MSCI EAFE	-2.76%	<i>International Stocks. An aggregate of 21 major country indexes, excluding the U.S.</i>
Wilshire REIT	+6.81%	<i>Real Estate. Measures the performance of publicly traded real estate equity.</i>
Lehman Bros. Aggregate Bond	+2.50%	<i>Bonds. Represents the performance of the entire US bond market.</i>