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MARKET COMMENTARY
FOURTH QUARTER 2004

General Comments –

This is the inaugural issue of our quarterly market commentary. During fourth quarter, Kelly Capital Management, LLC (KCM) officially opened its doors for business and relocated its offices to the address shown above. For many of you, our phone number will be a familiar one: it was our number at Addison Capital Management, the predecessor firm to the merger of Addison and Walnut Asset Management back in 2002. On balance, the quarter was marked by long hours and lots of attention to details. Our goal was to have everything up and running quickly with new, modern systems in place and client accounts on board. For the most part, it went rather smoothly. We thank all our clients and their financial advisors at various broker/dealer firms and banks (and their able assistants!) for their help in making the transition from Walnut to Kelly as smooth as it was.

As to the future format of this epistle, we expect to provide some general market observations followed by more specific comments broken down by investment strategy. That way clients can get an idea of what transpired during the quarter for each strategy. Of course, an investment performance review tailored for each client will be forthcoming. This quarter, the commentary is preceding the tailored reports.

We would like feedback from you as to what you like or may not, about the quarterly commentary. Our goal is to inform, not merely to fill your mailbox.

Market Observations –

The year 2004 ended with the second straight back-to-back yearly gain for the major market indices since 1999. Fourth quarter endured many geo-political events but came out unscathed. The outcome of the national election passed relatively quietly by market standards. This is most likely a testament to the market's favoritism of Republican fiscal policies which will likely be continued. We are also at war and the markets prefer consistency rather than change in such times. Disruptions, both actual and feared, drove oil prices to record highs and the Fed boosted interest rates to head-off inflation. Commodity prices were pushed up worldwide as a result of China's huge appetite for raw materials of every type. Gold hit a 16 year high. Real estate surprised the Street with a strong performance in the face of a rising equity market and rising interest rates. Lastly, there was a huge volume of merger deals which combined to push the worldwide volume of M&A activity to about $2 Trillion; a 40% or so increase over 2003.

Throughout the quarter, value and growth raced each other for the top spot at quarter's end. Value finished the quarter in the top spot (both Standard & Poors and Russell based indexes) in the large cap (big company) arena. In the midcap world, it was a tie. Overall, the S&P 500, Russell 1000 and Wilshire 5000 all finished the quarter well in the black. The consensus is that the markets will have another positive year in 2005, with broad indexes turning in another year of moderate gains. Comments below will refer to our individual strategies' results relative to the broader benchmarks. As a recap, our strategies are:

Large Cap Value
Midcap Core
Midcap Value
Large Cap Core—ETF
All Cap, Multi-Style—ETF
Balanced (anything with bonds in the mix)

Traditional Individual Company Stock Based Strategies:

<u>Large Cap Value</u> –

Large company stocks (a/k/a Large Cap) tended to under-perform mid-sized company stocks during the quarter. However, value generated over 1 percentage point more than growth in the large cap space. Our large cap value model's preliminary results indicate that we out-performed the S&P 500 benchmark by about 1% with Finance, Health Care, Telecom, Industrials, and Consumer Staples leading the rest of the sectors. Our goal for 2005 is to move toward more sector neutrality and place emphasis on good stock-picking and cautious sell discipline.

<u>Midcap Core & Midcap Value</u> –

Stocks of mid-sized firms generated total returns for both the 4th quarter and all of 2004 greater than those of larger companies. Within the midcap space, value and growth styles generated essentially identical total returns so "core" had an advantage over a style-based approach. Preliminary results for our midcap models (both core and value) indicate total returns in the low double-digits with midcap core eclipsing midcap value. Both models were close to their benchmark returns. As in large cap, our 2005 goal is to depend more on good stock-picking, cautious sell discipline, and remain relatively sector neutral.

Exchange Traded Fund (ETF) based strategies:

<u>Large Cap Core (formally known as Active Index Core)</u> –

Our Large Cap Core ETF (LCC) strategy tracks the return profile of the S&P 500 Index but with better overall diversification, better tax-efficiency and better total return over three-year and five-year rolling cycles than a S&P 500 Index mutual fund and better than the typical large cap core equity portfolio manager. During the fourth quarter our model's preliminary results showed modest strength against the benchmark index. This strength resulted from the contributions of the

NASDAQ 100 (QQQQ), Fortune 500 (FFF), and S&P Midcap 400 (MDY) ETF shares. Our exposure to the "Blue Chips" via the Diamonds (DIA) held us back a bit. Nevertheless, our model showed preliminary total returns slightly above the benchmark index for the quarter.

All Cap, Multi-Style (formally known as Total Market *PLUS*) –

Our All Cap, Multi-Style ETF (ACMS) strategy is designed to provide vast diversification combined with style, market cap and sector rotation. It is also referred to as a "Multi-Disciplinary Account" style. ACMS is benchmarked against broad market indices such as the S&P 500, Russell 3000 and Wilshire 5000 Indices. Preliminary results indicate that our model did well against all three benchmarks during fourth quarter. Our return was helped by exposure to the Technology sector (IYW), Midcap 400 Core (MDY), Small Cap 600 Core (IJR), and S&P 500 Equal Weighted Index (RSP). All of these ETFs generated double digit returns well ahead of all three benchmark indices' returns for the quarter. Only Health Care (IYH) provided a disappointing return below that of all three benchmarks. "Big Pharmaceuticals" were the culprits that dragged down the IYH return for the quarter. Our Industrials (IYJ) exposure generated returns ahead of two of the three benchmarks so the IYJ shares modestly contributed to the attractive results we experienced in fourth quarter.

Balanced Accounts –

Any portfolio strategy we manage for a client in which we include bonds (either taxable or municipal) in the client's portfolio is considered a "balanced account". Each client's asset mix is tailored to that client and may not look like any other clients' asset mix. Inclusion of fixed income in our balanced portfolios did not hamper generation of attractive total returns for the quarter. On balance, our strategy of investing in intermediate maturities, with high quality and call protection has paid off. As interest rates have risen, the fixed-income component of client portfolios has held relatively steady. Where feasible, our use of tax-exempt closed-end funds has added current income and appreciation in market value to the tax-free components of balanced, taxable accounts. Lastly, our selective use of fixed-income oriented ETF (SHY, IEF, LQD and TIP) shares has further helped client portfolios to maintain market value over the quarter.

Let us know your thoughts.

Kelly Capital Management, LLC