BERNARDI
SECURITIES, INC.
105 West Adams Street, Suite 1900 • Chicago, Illinois 60603
312-726-7324
fax: 312-726-1431
e-mail: bernardi@bernardisecurities.com
www.bernardisecurities.com

MID YEAR BOND MARKET REPORT

"Where have you gone Joe DiMaggio?"…Joltin Joe has left and gone away."

Years ago, Simon and Garfunkel wondered where Joe had gone. Today, bond investors too are asking that same question about deflation. All that buzz we heard last year about deflation has ceased and many investors are a bit bruised by what has transpired in the bond market over the past several months.

About this time last year, we had this to say about deflation:

> Deflation is the opposite of inflation…there is no doubt in our minds that Chairman Greenspan will battle the deflation threat with the same tenacity Paul Volker battled its evil twin over 20 years ago. Reinflation is Mr. Greenspan's goal. We suspect he, too, will prevail. Time will tell.
> *(Excerpt from Bernardi Securities, Inc., "President's Letter", 7/17/2003. To view complete text visit our Archives at www.bernardisecurities.com.)*

Indeed, time does tell all! Today, deflation talk is nonexistent and instead we worry about inflation. Rising interest rates in the first half of the year hurt bond portfolio performance, especially during the second quarter. As bond yields increased, prices declined. The value of the average U.S. taxable bond fund fell 1.9% in the second quarter. The average fund investing in long-term Treasury bonds fell 3.7% in this period. The 10-year Treasury note yield, which is used to set interest rates on mortgages, began the quarter yielding 3.84% rose to 4.9% and finished the quarter at around 4.7%.

The psychology of the interest rate market has changed dramatically since the beginning of the year. The Fed raised the U.S. benchmark interest rate by a quarter point on June 30th and said that further increases can come at a "measured" pace. More increases are clearly in store with the futures market expecting the Fed to add a full percentage point to the benchmark rate over the next 6 months.

Investors anticipating higher inflation and Fed rate increases pushed up interest rates throughout the second quarter. Greenspan for his part has stated that inflation is "not likely to be a serious concern" and predicted lower U.S. economic growth and weakening commodity prices.

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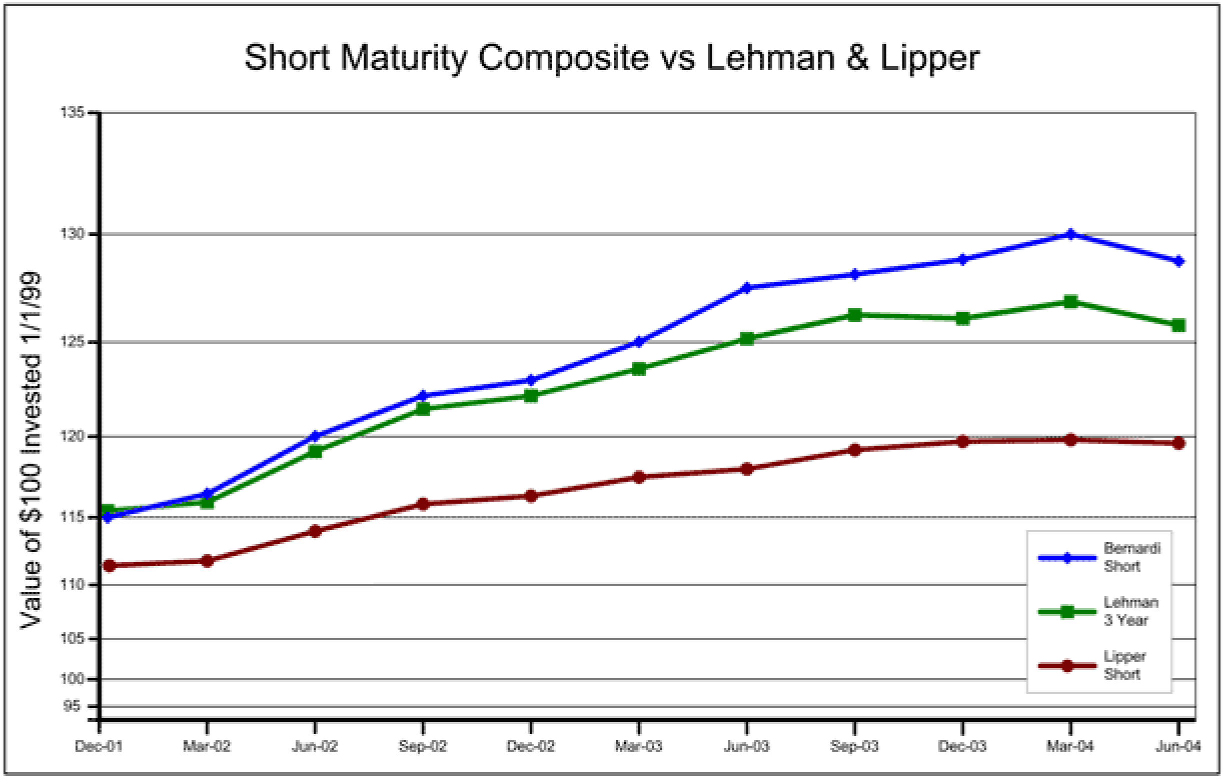
Bernardi Securities, Inc. client portfolios fared well in spite of the turbulent bond market these past several months. Our composite portfolios continue to perform well. The graph below shows the historical performance of our Short/Intermediate Composite Portfolio compared to Lehman and Lipper Indices:



Short Maturity Composite	Bernardi	Lehman 3 Yr	Lipper Short
1Q04	1.14%	0.92%	0.54%
2Q04	-1.26%	-1.22%	-0.55%
2004 YTD	-0.13%	-0.31%	-0.01%
Inception - 06/30/04	28.44%	26.13%	19.23%

As of 06/30/04

Last year we began reducing portfolio duration and lowering the average maturity of portfolios. We have also relied more on premium bond investments rather than discount and zero coupon type structures. This defensive portfolio management strategy has served your portfolio well in this volatile market. We will remain defensive, but willing to lock in attractive returns on longer maturity issues when good opportunities present themselves. In this type of market, these situations are often available.

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More Fed increases will raise bond yields and impact bond prices negatively, but no one can be certain by how much. The data below provides some historical perspective of past Fed rate increases and the corresponding affect on longer-term bond yields:

February 4, 1993 thru February 1, 1995:

Fed funds rate increased from 3% to 6%- plus 300 basis points:
10 year Treasury note yield increased from 6.26% to 7.65%- plus 139 basis points:

June 30, 1999 thru May 16, 2000:

Fed funds increased from 4.75% to 6.5%- plus 175 basis points:
10 year Treasury note yield increased from 5.79% to 6.44%- plus 65 basis points:

As you can see, in both periods the Fed funds rate increased substantially more than the longer term Treasury bond rate. We suspect that the same trend will occur this time around. This confirms for us that, while we want to continue with our defensive strategy, maintaining high money market balances awaiting the top of the interest rate market is **NOT** a sensible alternative. Remember that much of your bond portfolio's return is fueled by the interest paid on the reinvested income. As rates rise, the rate you earn on your interest (and maturing bonds) also rises because you are reinvesting in higher yielding bonds. While falling bond prices initially reduces the portfolio's value, the reinvested income earning higher yields often makes up the difference. As a result, the portfolio's total return increases over time as rates rise. You lose this effect if you keep too much money in a low paying money market.

Here is a bond portfolio that is well positioned for rising interest rates. It is defensively structured in anticipation of higher interest rates with minimal cash in a low yielding money market. Here are some relevant facts about the portfolio as of June 30, 2004:

Portfolio duration- 3.57
Weighted average maturity- 4.7 years
Average coupon- 5.457%
Average rating- AA1/AA+

We "stress tested" the portfolio in anticipation of changing interest rates. The purpose of this exercise is to approximate how much portfolio value is lost/gained for a given interest rate increase/decrease.

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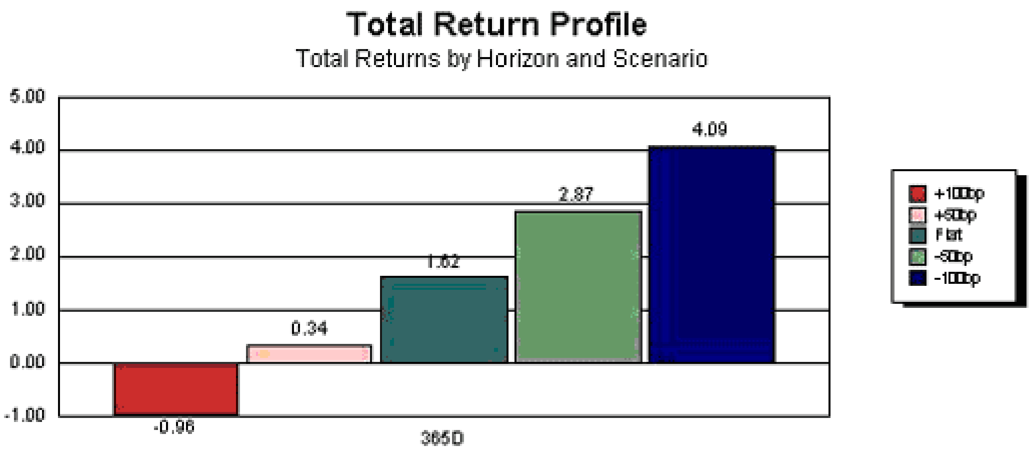

As the chart shows, the stress test indicates an approximate total return loss of 1% for a 100 basis point (1%) interest rate increase over the next 12 months. If we assume that interest rates decline the same amount, then the portfolio will realize a positive 4% total return. This is a risk/reward ratio we like and, in our opinion, indicates a well-positioned portfolio.

There is no doubt that we will see higher interest rates in the near future. There are corresponding risks and opportunities that come with this scenario. A key to successfully navigating thru this period is to manage the portfolio defensively and opportunistically.

We thank you for your continued confidence in our portfolio management team and welcome your questions and comments.

Sincerely,
Ronald P. Bernardi
President
July 2004

P.S. For additional market information please visit us @ www.bernardisecurities.com