

BUTTONWOOD NEWS

VINCE PASTORINO JOINS BUTTONWOOD!

We are happy to announce a new addition to the Buttonwood Team. During the excitement of the office relocation to 3013 Main, we took the opportunity to more formally confirm our relationship with Vince who previously worked with Franklin Financial Group. Vince will maintain the clients that he has been supporting and will now be able

to share the additional services offered at Buttonwood. With over 7 years experience as an investment advisor, he will be able to facilitate the increasing numbers of referrals that we have received from our dedicated clients.

Thank you for those referrals and continued trust in our services!

OPEN HOUSE / RIBBON CUTTING

Our Open House and Ribbon Cutting Ceremony will be August 4, 2005 from 3pm-7pm. Carmen's Cafe will be catering and music will be provided by Bram Wijnands. Please stop by and enjoy in the festivities.

3013 MAIN...improving your night's rest

Since 1908, 3013 Main has been a source for better sleeping. If it's through the relaxing comfort of beautiful artwork, comfortable furniture, a good mattress, clean linens or knowing your investments are being watched over, the professionals at 3013 Main keep watchful attention to your needs.

Preserving the architecture and maintaining the original charm of the building was the goal as we updated the amenities for a state-of-the-art finance firm.

Today, Buttonwood has embraced the

rich history of this building and has committed to maintain the beauty and spirit of revitalization that has been endorsed by its preceding owners.

We have dedicated our front display windows, dubbed **BUTTONWOOD ART SPACE**, to host regional artists. For our Open House, we will feature works from Jamie Lavin and Garth Fromme. For samples of their art, go to: www.jamielavincontemporaryart.com www.gnfimags.com

Dedication to David Sandweiss

We would like to dedicate this newsletter to David Sandweiss, a strong individual with creativity, intelligence and a heart of gold. David was an active in community development and has used his talents with advertising to help many local charitable organizations. He will be missed greatly by everyone who knew him.

At Buttonwood Financial Group, LLC, our mission is to positively impact each of our clients by providing ongoing consultative assistance allowing them to organize and take control of their financial lives. We accomplish this through education, financial planning, and the development and supervision of unique personalized portfolios for individuals, corporations and financial institutions.

Our growth comes from referrals, so please feel free to share our name and numbers with your family and friends.

YOUR BUTTONWOOD RESOURCES

Jon McGraw - President
Vince Pastorino - Senior Vice President
Wendy McGraw - Office Manager
Bill Ryan - Operations Director
Haumana Johannsen - Project Director

2ND QUARTER REPORT
JULY 2005

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Securities Offered by
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BUTTONWOOD

Financial Group, LLC

2ND QUARTER REPORT • JULY 2005

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THE STATE OF THE INVESTMENT ARENA

The U.S. economy turned in a solid performance in the first quarter with real GDP rising at an annual rate of 3.8%. All major domestic sectors – consumer spending, housing, business fixed investment, inventory investment, and government spending

contributed to growth. The major weak spot – net exports – continued to

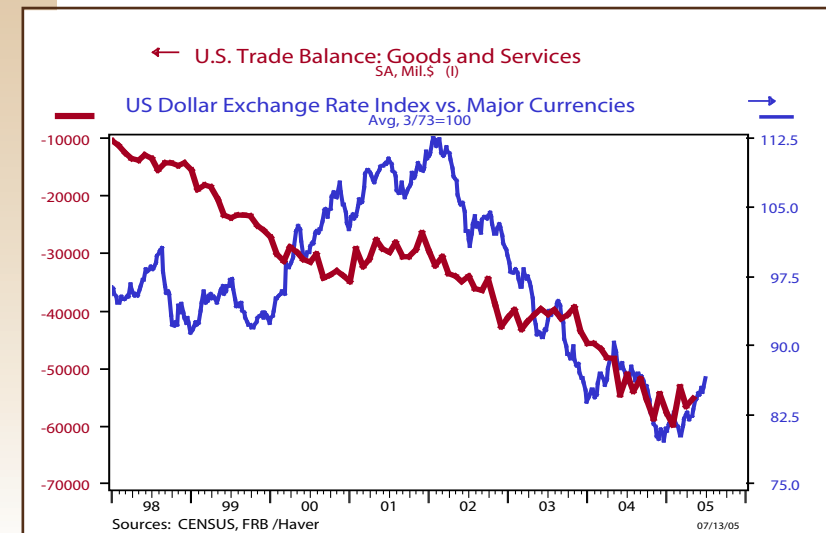
be a drag with the rising trade deficit reducing GDP growth by about 0.6 percentage points. The good news is that the trade deficit appears to have bottomed in February and reversed higher in March and May. The impact of the very low U.S. dollar exchange rate is likely at work here – cutting into imports and helping exports. (See Chart Below)

A factor likely to continue restraining growth in the economy is high crude oil prices and that negative pressure has intensified. Crude oil averaged a \$50 price per barrel in the first quarter and that rose to an

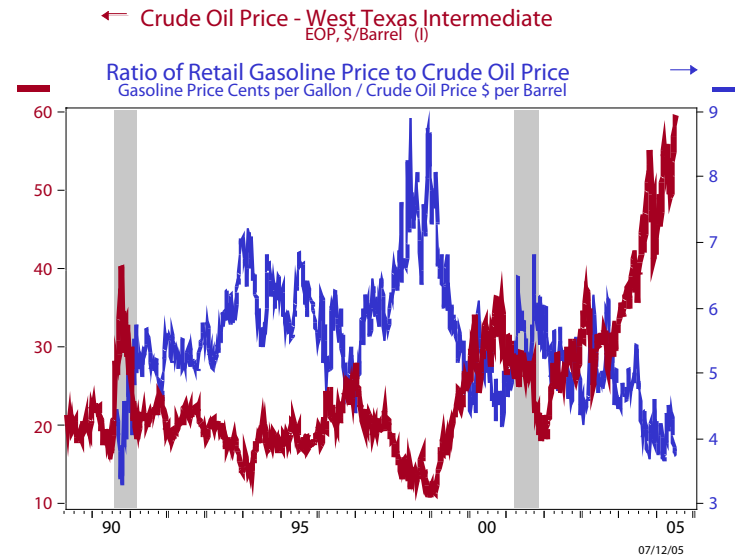
average of \$53 in the second, with the price finishing the quarter at just under \$60 a

barrel. OPEC members and others have blamed the rise in crude oil prices on a lack of domestic refining capacity, which in our opinion is a bit crazy. That would be like saying a crimp in auto production would make steel prices go up. Also, the ratio of U.S. retail gasoline prices to crude oil prices is at a 15 year low – one would expect that price ratio to be high if there were a serious refining squeeze.

We believe higher oil prices are the result of strong global oil demand on the one hand and OPEC supply restraint on the other. The drain of consumer and business incomes to overseas producers may subtract as much as a percentage point from U.S. GDP growth – that would



THE STATE OF THE INVESTMENT ARENA (Continued)



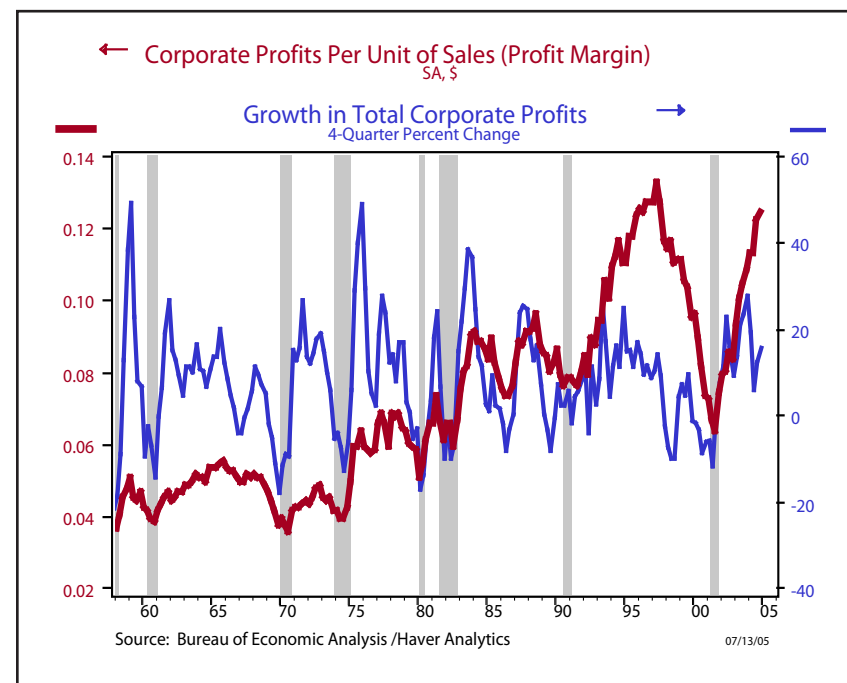
be about \$122 billion sucked away by OPEC. High oil prices are even more likely to figure into reduced growth in Europe and Japan. (See Chart above)

Other negatives facing us are the continued terrorist threat, now back on the map with the bombings in London, continued conflict in Iraq, sluggish growth in Europe and Japan, potential for further Fed rate hikes and a potential rise in long-term interest rates. However, not to be quite so negative, there are also powerful positive offsets. Besides a strong, well-balanced U.S. economy, the rebound in corporate profits, high earnings quality, and very strong aggregate corporate balance sheets bodes well for investment spending going forward. There

is a strong correlation between profits growth and investment growth.

And investment tends to drive employment and employment growth drives personal income and that drives consumer spending. This is the positive cycle that operates in the heart of business expansions. We believe that this process is hard to derail and it has been at work now for a while. With a look at chain store sales its easy to see negatives like higher oil prices and terrorist attacks can slow economic growth, but are unlikely to stop it.

So how much longer does all this work? Late in business cycle expansions, when costs begin to rise faster than prices, then profit margins get squeezed and profits start to slow, and prices have to accelerate to catch up. This margin squeeze begins to reverse the positive rotation process and the economy becomes vulnerable to recession triggers. At the present time, we are still seeing a rapid rise in profits per unit of sales

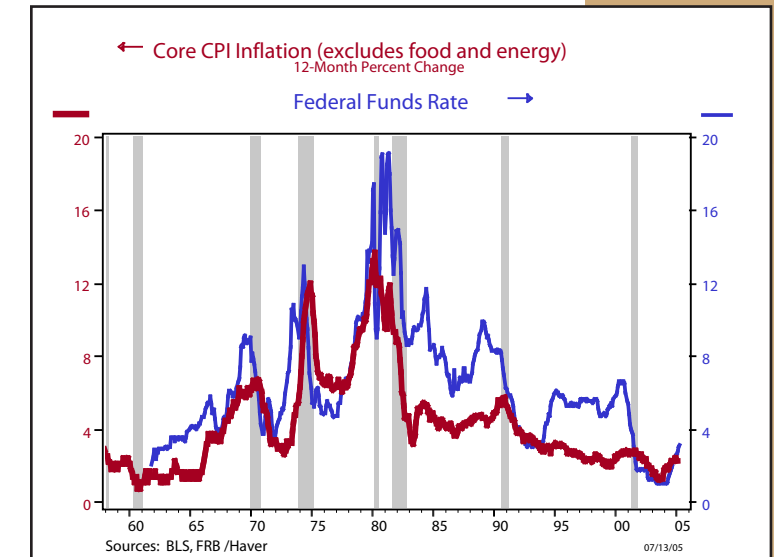
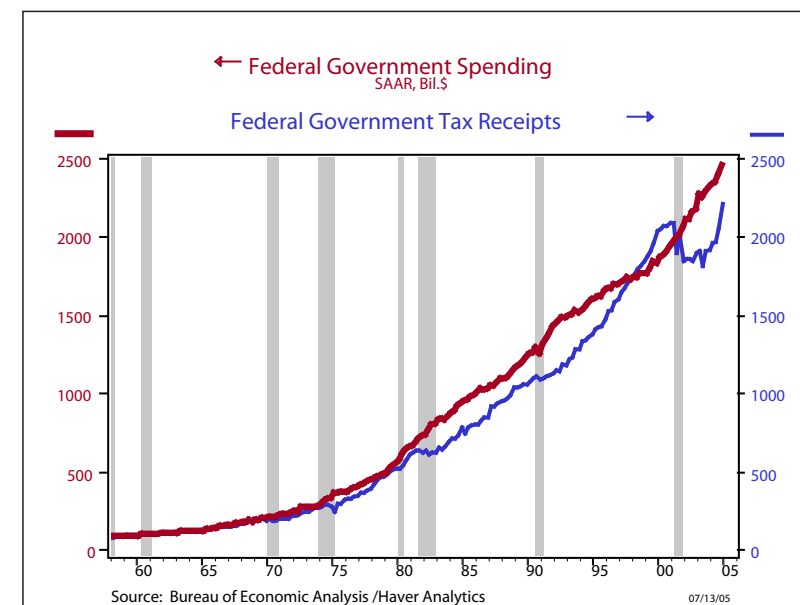


THE STATE OF THE INVESTMENT ARENA (Continued)

(the profit margin), with no squeeze in sight. (See chart below)

Also, late in the expansion, the Fed really starts hiking interest rates to cut off a “cost-push” inflation surge, and the fed funds rate rises well above inflation (see chart to the right). When that happens it is usually, but not always, enough to break the back of the expansion and a recession ensues. At this point, with the fed funds rate at 3.25% vs. a very modest core CPI inflation rate of 2.1%, we feel we are nowhere near these conditions.

Federal fiscal policy – spending and tax changes – remain pretty much on autopilot. As you can see from the chart below, spending continues to move along rising 6.4% over the last four quarters. Meanwhile, tax receipts have rebounded sharply, and that’s not because of any tax rate hikes! Rather this is due to the rapid rebound in taxable corporate and personal income. Total Federal tax receipts are up 15.1% over the last four quarters and the Bush Administration just cut its deficit forecast for this year by nearly \$100 billion. The good news here is that it does not appear necessary to resort to higher tax rates to close the budget gap.



So, with profits rising, no cost squeeze on profit margins, no cost-push price pressures, a strong, well balanced economy, monetary policy still not restrictive and tax rates unlikely to rise, we continue to believe the outlook for the U.S. economy remains pretty darn good. Last quarter we cited “two glaring weak spots – high oil prices and international trade.” Now we are mainly concerned about one – oil prices. We do feel oil prices this high (\$60+) will slow real GDP growth to 3.5%, but will still leave room for the positive cycle of rising profits pushing investment, which pushes employment, which pushes income and spending and so on.

Unfortunately it is just hard to be as optimistic on the major international economic areas – Europe and Japan. Both areas are experiencing sub-par growth – Euro-zone real GDP is up 1.35% over the last 4 quarters and Japan’s GDP is up 0.85%.



FAST FACT:

40% of Americans expect to retire before age 65...

33% of American Adults have not saved anything for retirement.

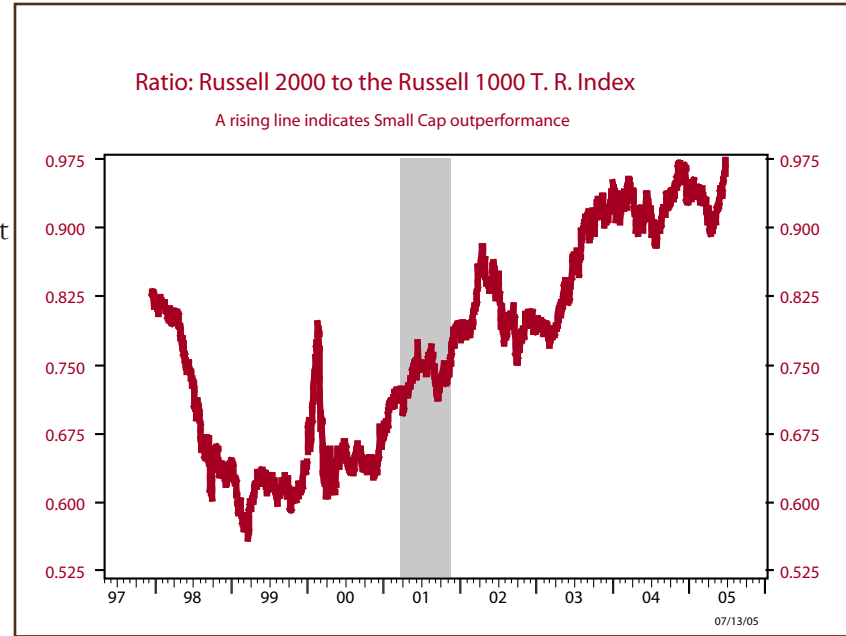
--Source: Gallup, Experian

THE STATE OF THE INVESTMENT ARENA (Continued)

This compares with growth of 3.7% in the U.S. There are some grounds for optimism. In Europe, the 3% limit on budget deficits relative to GDP had constrained most countries ability to consider tax cuts, but recent declines in budget deficits to below 3% in France and Germany as well as smaller deficits or surpluses elsewhere is stirring policy discussions of tax cuts. Also, some European politicians are starting to look at the positive results of major "supply-side" economic policies in Ireland (which has strong growth and a stable budget balance despite tax cuts). In Japan, there is no fiscal room at all, with deficits still sky-high.

Outside of the big industrial economic areas, growth remains fairly strong. China is still expanding rapidly, South East Asia may not be a "Tiger" anymore, but growth in the region remains steady. South America is doing fairly well and Eastern Europe and Russia remain strong. Of course, in all these regions specific country risk is always high.

In summary, we remain optimistic for U.S. economic growth prospects, even with the impact of high oil prices. We remain in the ballpark average of about 3.5% growth over the year. We do not see a significant surge in inflation, which has remained fairly well contained despite high energy prices. With inflation under control, we expect the Fed will stay with their "measured pace"



of rate hikes. That's been ¼ percent each meeting for the last 9 meetings. If so, the fed funds rate will end the year in the 4 to 4.25% range, not high enough to represent a restrictive monetary policy.

However, with rates continuing to move higher this may trigger a modest sell-off further out the yield curve helping to answer the "conundrum" question from Mr. Greenspan. The turnaround in the trade deficit removes a concern many had that the U.S. could not compete in global markets and the turnaround in the dollar exchange rate, in our opinion removes investment risk to foreign capital flows to the U.S. Our estimates have profit margins continuing to expand and we expect S&P 500 earnings to rise 10 to 15% this year. Hopefully, if we actually get all of that, we should see better second half performance from U.S. equity markets.

Outside the U.S., based on the items stated earlier, we do not view conditions in either Europe or Japan as favorable to equity investors and the rising, but still weak, dollar exchange rate adds even more risk for U.S. investors. Emerging markets continue, in aggregate, to show solid growth and many of these countries

THE STATE OF THE INVESTMENT ARENA (Continued)

currencies are either strongly linked to the dollar (China) or weakly linked (S.E. Asia) which lowers currency risk for U.S. investors.

RECOMMENDED ASSET ALLOCATIONS FOR THE THIRD QUARTER OF 2005

We are making limited changes to our tactical asset allocation recommendations for the third quarter, because we believe that the portfolio recommendations are well positioned to capture positive performance and limit risk. That said, the two overall changes we are making on the equity side are to continue to cut exposure to Small Caps and to cut exposure to Large Cap Foreign.

The cuts in exposure to Small Caps are in response to what we view as extended, and therefore risky, outperformance of Small Caps relative to Large Caps. More Small Cap funds are closing and some managers are reporting overvaluation. This quarter's cuts take the Small Cap weights down (roughly) to the Russell 3000 index Small Cap weight of 10%. So we are neutral, not underweight, to the index benchmark. The chart on top of page 4 plots the ratio of the Russell 2000 Small Cap total return index to the Russell 1000 Large Cap index. Mathematically, the ratio shows the cumulative return of Small Caps relative to

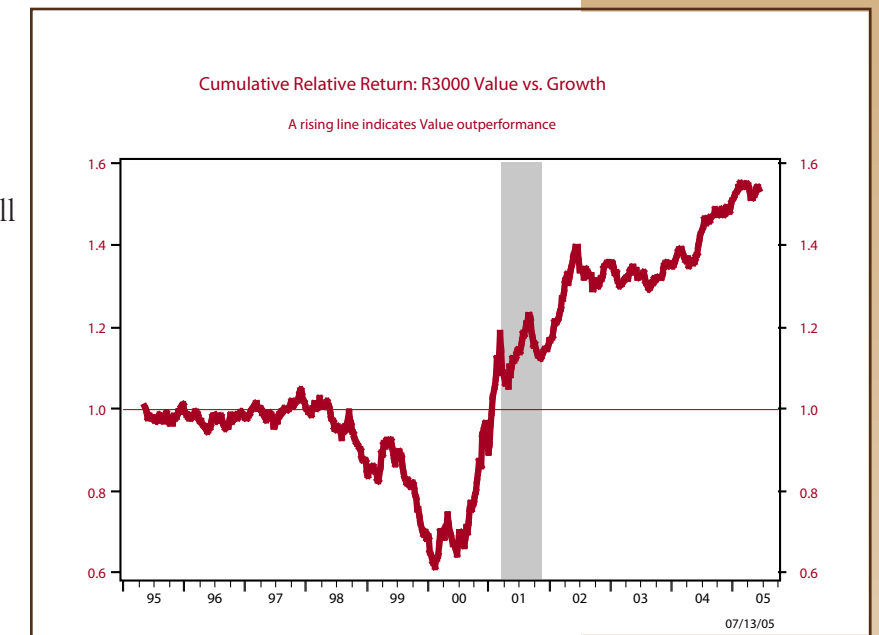
Over the last 5 years, Value has outperformed Growth by 90%.

Large Caps. As you can see, Small Caps have outperformed since the spring of 2000 by about 40%.

As shown in the chart, over the last two months, we have experienced a renewed burst of Small Cap outperformance. We are not at all sure what is driving that outperformance. Large Cap valuations look increasingly attractive and Large Cap company earnings have been improving.

Whatever it is, we are not willing to bet on this continuing. Having been strongly overweight Small Caps over the last six years, we think it is time to go to neutral and take the chips off the table.

We have also seen a similar sustained five-year performance run in Value relative to Growth. The chart below shows the ratio of the Russell 3000 Value total return index to the Russell 3000 Growth total return index. Again, the ratio measures cumulative

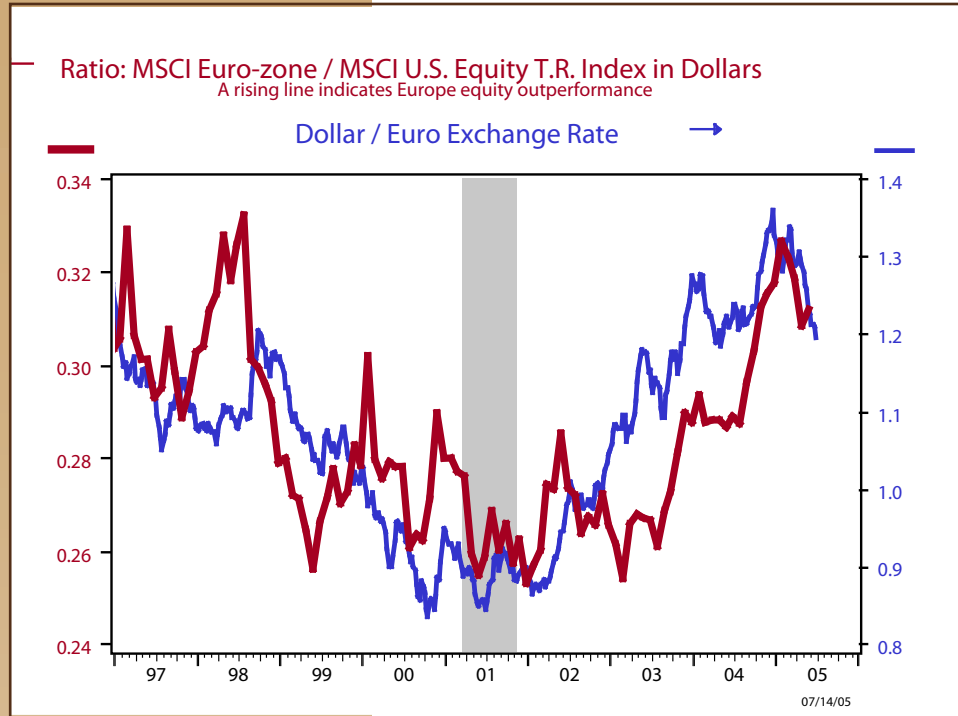


performance of Value relative to Growth. Over the last five years, Value has outperformed Growth by a whopping 90%. Again, we view this relative performance run as extended and therefore risky so we are staying with our slight overweight to Growth relative to Value in the asset allocation recommendations.

On the international side, we have cut our Large Cap Foreign exposure again, reducing it to less than half our normal exposure. Here as discussed above, the factors driving that decision are weak economies in Europe and



THE STATE OF THE INVESTMENT ARENA (Continued)



Japan and the weak but recovering dollar exchange rate.

The chart above shows the ratio of the MSCI Euro-zone equity total return index in dollars to the MSCI for the U.S. The other line is the euro exchange rate. They tend to move together. Based on our expectation of further euro depreciation

we are increasing our underweight to Large Cap Foreign. Since this asset class has a strong value bias we allocated the cuts here to Large Cap Value. For Emerging Markets we are retaining our small overweights, but with the dramatic cuts to Large Cap Foreign we are now in the unusual position of having the same recommended weights to both asset classes.

For fixed income we are not making any changes this quarter. We remain overweight High Yield, overweight High Quality Short/Intermediate and underweight High Quality Intermediate / Long-Term. In essence we have structured the fixed income asset allocation to maintain a significant credit bet (High Yield) and have removed the duration bet (underweight Intermediate/Long). The High Yield Rate and the spread to the 5-Year Treasury note yield are shown in the chart below. High Yield rates and the spread rose earlier this year with the downgrade of GM bonds, but lately High Yield is recovering. We are

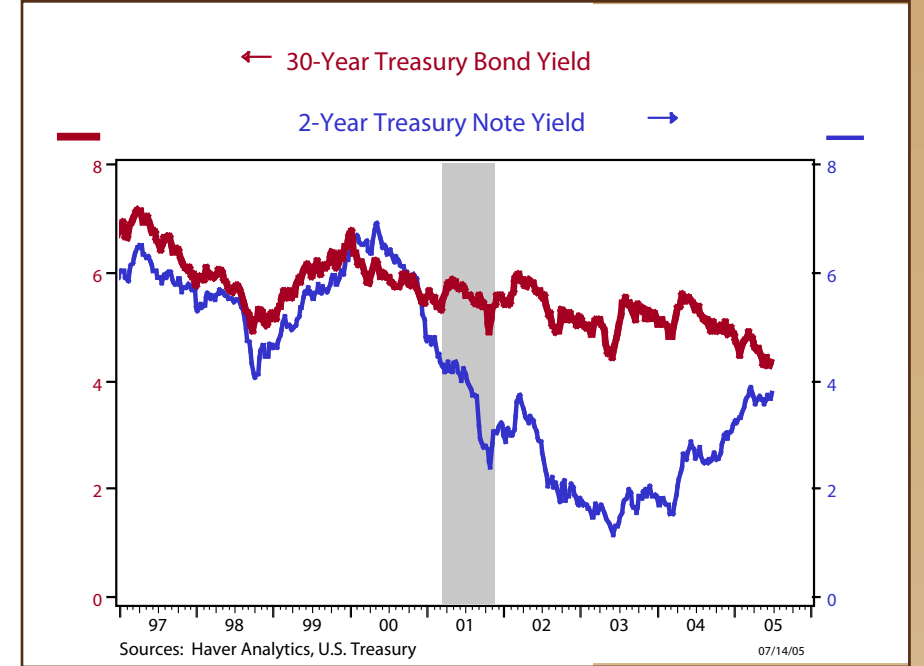


THE STATE OF THE INVESTMENT ARENA (Continued)

watching this market closely and expect to reduce our overweight down the road. However, for now we believe that the strong rise in earnings will drive High Yield rates down and tighten the spread.

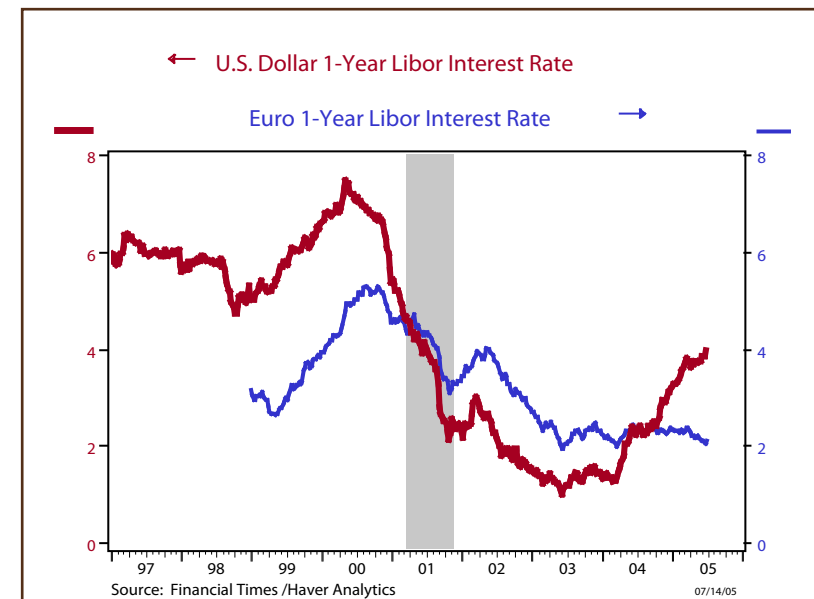
On the duration side, the yield curve is very flat right now. As shown in the chart to the right, the rise in the 2-year yield has had no impact on the 30-year yield and the 30-year yield is now only 55 basis points higher than the 2-year yield. We do not view this as adequate compensation for the price risk in the event of a rise in interest rates. Hence our underweight in the High Quality Intermediate/Long asset class.

We continue to recommend an overweight in Foreign Bonds given the slow growth and low inflation in Europe and Japan. This has been a good decision as interest rates in Europe have fallen over the first half of the year. One-year labor rates for the euro and the dollar are shown below. Over the last year, U.S. short-term rates have shot up, while Euro rates have fallen. This is another reason why we expect dollar exchange rate appreciation - the move from minus 100 basis points



to plus 200 basis points in the interest rate differential over the last year. Again, we want to emphasize that we are solely recommending investments in currency hedged Foreign Bond funds. We continue to view the risk of owning unhedged Foreign Bonds as unacceptably high.

In conclusion, we believe the tactical asset allocation recommendations for the third quarter are well positioned to take advantage of an advance in equity markets while positioned to manage valuation risk. For fixed income we think we are positioned



to avoid much of the damage that continued Federal Reserve rate hikes might deliver to the long end of the bond market, while maintaining enough longer-term exposure to provide some protection (a "shock absorber") against the unanticipated negative developments.

Past Performance is not an indicator of future results.

