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What I Am Thinking - Big Picture

For the second consecutive year, the majority of the broad equity indexes finished in negative territory. As far as millenniums go, the New Millennium has been disappointing from an investment performance standpoint

Having said that, domestic equity market performance in the 4th quarter of 2001 was incredibly strong, largely fueled by the power of massive central bank provided liquidity. I must admit that I underestimated the effect that this seemingly limitless central bank liquidity would have on the global markets; however, it has become clear that in times of emergency, the system works.

In many ways, I think the system may have worked too well. The Fed's post-9/11 actions have more than stabilized an unstable situation; it has made money cheap and leverage easy. At these levels, the domestic equity markets seem to have discounted any fear of further terrorist attacks or the likelihood that corporate earnings will be anything less than stellar. There seems to be no risk premium priced into the market, and with the uncertainties in the global economy and the cloudy picture for corporate earnings (additional terrorist acts notwithstanding), perhaps there should be.

Hedge fund manager and former Managing Director of Quantitative Research at Goldman Sachs Asset Management, Clifford S. Asness, Ph.D. has written an interesting academic paper ("The Bubble Has Not Popped" available at www.aqrcapital.com) commenting on the current valuation of the domestic equity market from a price/earnings ratio (P/E) standpoint. In this paper, Dr. Asness concludes that while equity prices have fallen in 2000 and 2001, actual corporate earnings have fallen much more so, resulting in market P/E ratios that are still near their historical highs. Cliff is a former business associate of mine and a very bright guy.

As 2002 begins, I continue to be worried about inflation and the quality of corporate earnings in the post 9/11 world. It is no secret that he largest beneficiary of the liquidity-fueled fourth quarter rally has been the technology sector. In the absence of an actual recovery in earnings momentum for this sector, I feel the valuation for technology stocks may have gotten too high from a risk/return standpoint. The upcoming fourth quarter earnings season should be very interesting.

Let's hope 2002 is better than 2001 in every way.

Asset Allocation – Tactical vs. Strategic

Our past discussions of asset allocation in the WIAD Newsletter have focused on *strategic* asset allocation. *Strategic* asset allocation is the formulation and implementation of a long-term investment portfolio plan that determines a mix of diversified asset classes by taking into consideration an investor's risk profile and investment horizon. Once this plan is determined, the investor must be disciplined to

rebalance the portfolio periodically to maintain the original portfolio weights. *Strategic* asset allocation plans are rarely changed, and portfolios should be rebalanced periodically (usually annually) due to changes in asset values over time.

Tactical asset allocation is often used in conjunction with a strategic asset allocation plan. While strategic asset allocation plans set defined limits for asset classes within a portfolio (i.e. 60% domestic equities, 10% international equities and 30% domestic fixed income) for a given investor's long term risk and return expectation, tactical asset allocation allows for shifts within specific asset class limits while maintaining the original strategic asset allocation plan's risk and return expectations. For example, while a portfolio's strategic allocation to equities is 60%, an investor may want to reallocate a technology exposure within the 60% equity allocation that has risen beyond an acceptable risk/return valuation in favor of other sectors (such as energy or utilities) that may have fallen to risk/return valuations that have become attractive.

Tactical asset allocation is a contrarian investment strategy, and can be useful as a portfolio risk management tool.

2001 Review

Concepts

In 2001 we discussed the importance of having a long-term strategic ***asset allocation*** plan and the importance of understanding the concept of ***correlation*** and how it relates to risk and return. There is more to portfolio ***diversification*** than just having a lot of individual holdings in a portfolio. Diversification can only decrease portfolio risk and increase portfolio return to the degree the asset classes included in the portfolio have *uncorrelated* historical return characteristics. It is also important to remember the actual buying of individual securities and/or funds should be the last and least complicated step an investor takes in constructing a properly allocated and diversified investment portfolio.

In terms of ***portfolio tax-efficiency***, the determination of what type of account (***taxable or tax-deferred***) you place your assets can make a difference. A prudent, tax-aware portfolio manager should first decide on what types of asset classes he wants/needs to hold in aggregate (based on risk profile, return characteristics and time-horizon/holding period), then decide the percentage allocation of those assets that should be held (the strategic asset allocation plan), and only then deciding where and in which type of account (taxable vs. tax-deferred) those assets should best be held.

For taxable investors, a good guideline is to keep your higher volatility/growth-oriented positions in your taxable account (pay tax at the capital gains rate and have the ability to take capital losses to manage your taxes) and allocate your lower volatility, income-producing or tax-inefficient assets in your tax deferred account (defer paying *income* taxes until retirement possibly at a lower income tax rate, and have a lower risk of unusable capital losses). In a well-diversified investment portfolio, it is important to have both types of assets; the art is knowing where to put them. Remember the golf bag analogy.

While a good problem to have***, it is possible to have too much money in a tax-deferred account***. Only put as much in tax-deferred accounts as you can spend in retirement while you are alive. Don't make Uncle Sam a member of the immediate family!

Tax loss harvesting is an important part of portfolio management for investors who pay taxes. Investment losses can be valuable, especially in years when you have capital gains in your portfolio. Taxable investors should always try to harvest their tax losses in years that they have them. Holding

investments at a loss (against your cost basis) when you have realized capital gains in your portfolio is a missed opportunity to limit your tax bill.

Stop loss orders can be a useful portfolio risk management tool. Stop orders are generally used to protect a profit or to prevent further loss if the price of a security moves against you. With a stop loss order, if the stock you think is too high stays in a trading range or goes up, nothing happens, the order goes unexecuted. If the market takes a meaningful move to the downside (due to war, unexpected bankruptcy, or other disappointing news), the stop loss order gets you out at the next market price after the specified stop level is reached.

Ideas

We discussed a few specific investment ideas in the WIAD Newsletter in 2001. While I am a firm believer in strategic portfolio asset allocation and using passive, tax-efficient investment vehicles, on occasion, it is okay to dedicate a small percentage of one's portfolio to tactical asset allocation strategies and specific securities trades. Consider the review of these 2001 investment ideas as part of a non-core portfolio and/or for entertainment purposes only.

Tactical Asset Allocation to the Utilities Sector

My rationale for making a tactical allocation to the electric utilities sector originated when the Senate Banking Committee voted (19 to 1) earlier this year to repeal Public Utility Holding Company Act of 1935 which was a law that that restricted ownership and operations of electric utilities. Earlier this year Warren Buffett publicly stated he had $10 to $15 billion to invest in the electric utility market if this law was repealed and announced he had taken a 4% position in GPU and was expected to take positions in others if the law was repealed.

So far, this idea hasn't worked out for the sector as a whole. In June, I purchased the IDU ETF (Dow Jones Utilities Index) and GPU (a regional electric utility) to make a tactical asset allocation into the electric utilities sector. The IDU position fell 16.9% in the second half of 2001, but GPU was acquired by First Energy and returned approximately +11.3% in the second half of 2001. As technology stocks return to unattractive risk/return levels, utilities seem inexpensive.

Lucent Bonds

In July, we discussed the idea of buying Lucent corporate bonds as a safer alternative to owning Lucent stock. So far, this one has worked. In the last 5 months of 2001, Lucent stock returned – 5.97%. At the same time, the Lucent 6.45% of 3/15/2029 corporate bond returned +12.85% (purchase price: $64, semi-annual interest payment received: $3.225, closing price 12/31/01: $69). Stocks and bonds from the same company have significantly different risk and return characteristics, as they should.

At the right price, an investment in Lucent senior long-maturity corporate bonds has the benefit of having upside potential in both good and bad scenarios for Lucent (the Company). If Lucent flourishes, the bonds (purchased at a deep discount) mature at par: the bondholder receives a nice double-digit total return (interest payment & appreciation to par). If Lucent goes under, while the common stock holders lose their entire investment, the bondholders and bank lenders are first in line to reorganize or liquidate the Company's assets.

The big question is: what Lucent's assets are worth in a liquidation scenario? Based on an analysis of Lucent's financial statements, an argument can be made that in a worst-case scenario, the Company's assets in liquidation would be sufficient to pay at least 65% of the Company's senior debt. This makes Lucent's long maturity corporate bonds an interesting investment in the $60 to $65 range. While still risky, Lucent's bonds are less risky than their stock.

TIPS/I Bonds
A simple definition of inflation is: too much money chasing too few goods. With the Federal Reserve flooding the financial system with liquidity for the past 12 months, there is quite a bit of cheap money in the system.

As US interest rates are at historically low levels, an investor must approach any strategic asset allocation rebalancing into bonds carefully because investing in bonds in a rising rate environment can have negative return characteristics. While I do not believe in market timing when it comes to asset allocation decisions, I do believe that in general, the likelihood US interest rates go up from current levels over the long run is greater than the chances they go down (with 1.75% Fed Funds rate and 30-year US Treasury bonds yielding below 5.50%, there isn't much more room to go down).

Consider Treasury Inflation-Indexed Securities (also known as TIPS) and I-Bond US Savings Bonds. These are fixed income securities issued by the US Treasury that pay a rate of interest that is determined by an inflation rate index. These securities are designed for investors seeking to protect the purchasing power of their investment against inflation and earn a guaranteed real rate of return.

If interest rates go up, it is likely it will be as a result of inflationary pressures, TIPS and I Bonds may be a good alternative to add to the fixed income asset sector.

December Investment Results:	**December**	**Last 3 mo**	**YTD**
NJL Equity/Income Aggregate	1.69%	9.43%	-8.06%
S&P 500 (including dividends)	0.88%	10.69%	-11.89%
Russell 3000 (including dividends	1.41%	11.76%	-11.46%
MSCI World (in US $, price only)	0.56%	8.36%	-17.83%

***Note:** The NJL Equity/Income Aggregate is a multi-cap global equity composite that is reflective of my aggregate investment portfolio's performance. The composite returns are comprised of over 98% global equities and cash and less than 2% domestic fixed income and include taxable and tax-deferred portfolios. The composite returns are unaudited and are calculated using AIMR Performance Measurement guidelines.*

A Final Note
2001 was a tough year.

As we all know, everyone is a genius in a bull market. However, it is during difficult markets that the importance of well-conceived asset allocation plans and disciplined portfolio-rebalancing strategies cannot be over-emphasized. It is these often difficult decisions and the disciplined implementation of these strategies that allow long-term taxable investors to benefit when the good markets return.

I hope you have enjoyed reading the WIAD Newsletter in 2001. WIAD Volume 2 begins with next issue.

Nelson J. Lam
The Lam Group, Inc.
January 9, 2002

Coming in 2002:

- 529 plans
- The importance of tax efficiency
- Passive vs. active investment management
- A new and improved website for The Lam Group, Inc.

The archives for the WIAD Newsletter are available at: www.thelamgroup.com/wiad.htm

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