# The Lam Group
Investment Management

**The Lam Group Newsletter Vol. 2, No. 2**
**Second Quarter 2002**

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**What I Am Thinking - Big Picture**
I am beginning to become optimistic about the intermediate to longer-term prospects of the US equity market. With the corporate accounting scandals, the senior-level executive misconduct as well as the increasing unemployment rate of skilled workers generated from the crashes in the technology, telecom and other large industries such as financial services, the equity and bond markets to finally starting to behave more rationally. This market behavior is much more reflective of our current domestic economic situation and a far cry from the "patriotic" market behavior of the 4th quarter of 2001 and the 1st quarter of 2002. During those periods, the US markets were going up for reasons that were disconnected from earnings performance and the overall health of the economy. Now we are down, but for very understandable reasons. Why then, am I beginning to be become optimistic? Three reasons:

***Accounting Scandals:***
From a "glass half full" perspective; we are at a critical turning point. It has become clear that the leadership at least one of the major accounting firms and significant members of corporate America have lost their way and deviated from their moral and professional responsibilities. They cheated and the helped their clients cheat. With all the media and regulatory scrutiny that the Enron, Arthur Anderson and WorldCom debacles have generated, this can happen no longer. Any accounting firm that cut corners in the past for their clients will not be able to do so in the future. As a result, I think we can expect corporate earnings to be much more conservatively stated (read: disappointing) in the future. In the near-term, we can expect few surprises to the upside from a corporate earnings reporting standpoint and that there will be some big disappointments in the next quarter or two. These disappointing results will be the preamble to broad regulatory reform and lead to a return to believable financial reporting and provide a basis for renewed investor confidence.

***Corporate Governance/Leadership:***
Enron, ImClone, Tyco, WorldCom, etc. Its amazing the stuff the Boards of Directors of major companies will let their senior management get away with. Again with all the media and regulatory scrutiny, shareholder robberies by corporate leadership can happen no longer. Reforms at the corporate level such as those proposed by the NYSE (http://www.nyse.com/pdfs/pc_comparison_chart.pdf) as well as the CEO/CFO accountability reforms proposed by the SEC are necessary and a significant first step in towards more responsible corporate governance. The effective implementation of more ethical leadership and responsible governance will take time and will offer investment

opportunities as the bad elements of the system are exorcised from their current leadership positions and management roles.

***Unemployment:***

*"Necessity is the mother of invention"*

Also from a "glass half full" perspective, large-scale unemployment of skilled workers and professionals can be a good thing for the economy in the long term. The technology, telecom, financial services and other areas that employ skilled workers and professionals have been hit hard by layoffs and cutbacks. These people will have to find another way to be successful and will have to consider positions and career paths they have never considered before. The necessity of looking for alternative career and business opportunities, or thinking of ways to start a profitable business will bring fresh ideas, perspectives and energy into areas of the market and economy that are in desperate need of highly-motivated, intelligent and well-trained people.

This new necessity also applies to the new top graduates of universities and graduate business programs. No longer can these young people go en masse into the "easy money" professions of management consulting and investment banking, professions that annually steal the best and the brightest graduates. These bright and motivated minds will have to look elsewhere to begin their careers. There will be areas of the market and the economy that will benefit from the fresh ideas, perspectives and energy of young, ambitious grads that have nothing to lose by trying.

It is a common misconception that there is no venture capital or private equity money out there to fund new ideas and businesses. With capital raising frenzy in 1999-2000, it is estimated that there is over $50 billion in committed, but still uninvested venture capital and private equity money out there. For the venture capital or private equity investor, it has never been easier to find talented people who, in the face of growing unemployment, are willing to take some risk with their careers.

*Market downturns are never as short as one would like, but are never as long as one fears.* Given the accounting and corporate governance reforms that must take place in the near term, the next quarter or two will be extremely ugly, however I am beginning to feel that the light at the end of the tunnel may not be an on-coming train. With the market down at these levels, the common excuse of not rebalancing a portfolio to maintain an asset allocation strategy due to an unwillingness to pay capital gains tax is less of a problem than it may have been in the past.

Take the time to examine your investment portfolio versus your asset allocation plan and rebalance as necessary; knowing what you own and why you own it will be important as we enter tax-loss harvesting season.

**Marketing Works I - Apples and Oranges**
With the S&P 500 down for the third consecutive year, many mutual fund companies are touting their three-year performance records versus the S&P 500. What is interesting to note is that many of the mutual funds that claim “S&P 500-beating” performance are not domestic large cap funds, and as a consequence are not good or fair comparisons to the S&P 500. Remember, the S&P 500 is merely an index of the large capitalization domestic stocks; that is all. While it is true there are very few actively managed large cap mutual funds that have better performance records than the passive S&P 500 index when measured over long time horizons, there are many domestic equity funds that have long-term performance records better than the S&P 500. These S&P 500-beating domestic equity funds are not in the large cap asset class.

*In an efficient market, the cost of capital and the expected return for a given company should be the same.*

In general, small cap stocks are riskier than large cap stocks. As a result, small cap stocks should have a higher expected return. If this were **not** the case, why would anyone buy small cap stocks instead large cap stocks? For example, if a large, diversified company like General Electric (GE) had an expected return of X%, what positive increment over X% would an investor need to accept the additional risk of investing in a smaller, less liquid, less diversified, less well-known and financed company? A rational investor would have to expect a positive premium to the return of the larger cap company to make an investment in a riskier company.

As a consequence of this “capitalization” based difference in expected return and risk, the idea of comparing the performance of domestic large cap equity indices such as the S&P 500 to the performance of domestic small cap sectors such as the Russell 2000 or the CRSP 6-10 is like comparing *apples with oranges*. Domestic large cap and small cap stocks are separate asset classes each with own distinct return, risk and historical performance correlation profiles.

**Table 1 – Historical performance of domestic large and small cap indices. 1/26 – 6/02**

| Index | Annualized Return | Risk (Standard Deviation) | Correlation w/ S&P 500 |
|---|---|---|---|
| S&P 500 | 10.55% | 19.5 | 1.000 |
| CRSP 6-10* | 11.66% | 27.7 | 0.865 |

* the CRSP 6-10 is a broad-based domestic small cap index that will be described and discussed in greater detail in the 3Q2002 newsletter. It is a more accurate indicator of small cap performance than the more popular Russell 2000.

While the excess return generated by the domestic small cap equity asset class is accompanied by greater risk, over the long-term, small cap stocks should return more than large cap stocks. Additionally, the domestic small cap asset class is only more risky than the large cap asset class when viewed in isolation. Because the returns of the two asset classes are not perfectly correlated, the addition of the domestic small cap equity asset class to a domestic large cap equity investment portfolio can reduce portfolio risk and increase return. While it is not good to *compare* apples with oranges, it is good to *have both.*

As a side note, since starting my investment advisory and management firm earlier this year, many potential clients have asked me to critique their investment portfolios. It is interesting to note that even though many of these portfolios consist of several mutual fund holdings, all of these multiple holdings have been domestic large cap equity funds. When asked why only large cap funds and why so many, the universal reply has been: "Diversification?"

Holding only one asset class in an investment portfolio is not diversification no matter how many different ways that one asset class is held. Owning only one asset class is risky and more commonly known as "*holding all your eggs in one basket*".

Portfolio diversification means owning multiple asset classes with low relative correlation to one another. This diversification can only occur in the context of a disciplined asset allocation plan. Investment portfolio management is neither an art, nor a science. In my opinion, portfolio asset allocation is where art and science meet.

| **2Q 2002 Asset Class Investment Results:** | **2Q 2002** | **YTD** | **12 mos** |
|---|---|---|---|
| NJL Equity/Income Aggregate | - 4.89% | - 2.80% | - 8.80% |
| Wilshire 5000 (Domestic Total Market) | -12.61% | - 11.77% | - 16.62% |
| S&P 500 (Domestic Large Cap) | -13.40% | - 13.16% | - 17.99% |
| CRSP 6 -10 (Domestic Small Cap) | | | |
| MSCI World (Global Equity, in US $, price only) | - 3.90% | - 3.15% | - 16.31% |
| Wilshire REIT Index | + 4.59% | +13.34% | +16.02% |
| Lehman Gov't/Corp 1-10 (Domestic Fixed Income) | + 3.55% | + 3.32% | + 8.17% |

*Note: The NJL Equity/Income Aggregate is a multi-cap global equity composite that is reflective of my personal aggregate investment portfolio's performance. The composite returns include taxable and tax-deferred portfolios. These composite returns are unaudited and are calculated using AIMR Performance Measurement guidelines. Past performance is no guarantee or indication of future results.*

This will be the last Newsletter where the NJL Equity/Income Aggregate investment return is published. In future Newsletters I publish the specific returns of the asset classes The Lam Group actually uses to construct client portfolios. By using these asset class returns rather than the returns on a specific portfolio, it will be easier to discuss asset class allocations over a more broad risk profile. Over time, I expect to construct a generic model portfolio for purposes of topical discussion for this Newsletter.

**The Lam Group:**
In our first full quarter of operation as a Registered Investment Advisor, The Lam Group now has over $15 million in assets under management, with clients in Oregon, Washington State, California, New York and New Jersey. Portfolios managed for our clients include those for taxable investors, a family office, and a private tax-exempt foundation.

# The Lam Group
Investment Management

While a new and still relatively small RIA, The Lam Group enjoys the perks of being an institutional investor. As a result, our clients have access to institutional investment products, such as the DFA Funds that are not available to retail high-net worth investors. Additionally, we can purchase (with few restrictions) the institutional class shares of PIMCO funds in amounts well below the stated $5 million initial investment minimum.

The Lam Group will take a limited number of additional clients in 2002. A prerequisite for becoming a client is a belief in, or at least a willingness to understand passive investment management in the context of a disciplined asset allocation strategy.

Nelson J. Lam
The Lam Group, Inc.
July 15, 2002

Topic for Next Quarter:
Marketing Works II. Domestic Small Cap Equity Performance Measurement – Not all apples are the same.

The Lam Group Newsletter (formerly the WIAD Newsletter) will be published quarterly in 2002. Archives for The Lam Group Newsletter are available at our website: www.thelamgroup.com