The Lam Group

Investment Management

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The Big Picture – The Unintended Costs of War

In these uncertain times, a few things are certain: War is expensive.

This war is particularly expensive because we did not get UN support before invading Iraq. From an economic standpoint, UN support was critical to determining who will help pay for the war effort. As a result of this lack of support, the US will have to pay for the bulk of the costs of going to war itself. According to *The New York Times*, the federal budget deficit, before taking the war into consideration, was estimated to be almost $300 billion. The war, even if short in duration, can only increase our budget deficit. How will we pay for our large and growing deficits?

I suspect the US will fund its war efforts and pre-election year economic recovery by printing money. The US Federal Reserve can “print” money by keeping short interest rates low and the US Treasury can “print” money by issuing US government bonds (possibly causing long interest rates to rise). It is likely that in these times of geopolitical uncertainty and economic weakness, no other country will print as much money as quickly as the United States of America.

Deficit spending, despite the patriotic nature of our actions in Iraq, will come at a cost to investors, particularly to those who focus only on domestic and US-$ based asset classes. The growing oversupply of US dollars in the global marketplace will weaken its value against the currencies of other countries. As a consequence, there is a high probability that US $-based assets may underperform non-$ assets on a relative basis.

Additionally, with the Fed’s current accommodative monetary policy stance and the possibility of stimulative pre-election year fiscal policies, it is likely that domestic inflation (too much money chasing too few goods) may be a problem soon. As most investors should know, inflation is the enemy of traditional US-$ denominated fixed income investments.

The explicit geopolitical risks of the war have been widely discussed and analyzed daily in the news media. It is worth noting that there may be unintended by-products of our ongoing geopolitical actions that will have negative ramifications for the strength of the US $ and the possibility of domestic inflation. These implicit economic by-products of war (and more importantly, post war) represent issues that are not discussed often enough given the risks they represent to investors.

The first casualty in the post-war period may be the US $-based, investment grade US bond market. As many investors have never seen or experienced rising interest rates, domestic inflation and/or an extended period with a weakening US $, it is important to be prepared for the future.

While The Lam Group believes it is important to stay disciplined within a long-term asset allocation plan, we also believe it is also important to make tactical adjustments within the plan in recognition of market cycle extremes**.**

With US interest rates at 45 year historical lows and with potential domestic inflation on the horizon, we have modified our fixed income sector exposures to include more non-$ investment grade bonds (w/currencies unhedged), Treasury Inflation Protected Securities (TIPS), and short duration products, and we have decreased our exposures to traditional domestic investment grade bonds, especially longer duration fixed income products.

Investment Concept: The Perils of Patriotic Investing
The war in Iraq has taken investor's focus off the state of the domestic economy. For the time being, it appears we are in the midst of a "patriotic" rally, reminiscent of the one experienced in the 4th quarter of 2001, which occurred subsequent to the terrorist attacks on 9/11. Leading the current rally are growth-oriented domestic large cap stocks.

You may remember for 4Q2001, the S&P 500 was up over 9.8% despite the fact that our economy was in deep trouble and the US was dropping bombs on Afghanistan. You may also remember that in the 12 month period following the 4Q2001 "patriotic" rally, the S&P 500 was down over 21.6%, largely due to the realities of the poor domestic economic environment. With the current patriotic rally that started in early March, the S&P 500 is now essentially flat for the year, after being down more than 8.5% YTD before the hostilities began.

The reason I mention this recent market history is because I believe the current level of equity market euphoria is more emotional than fundamental. While we may or may not be closer to a safer and more peaceful world, our economic and unemployment situations are no better (and in some cases worse) than in 2001 or 2002. If the domestic economy doesn't improve soon, this current "patriotic" rally in domestic large cap stocks will not have legs.

With short-term interest rates at 1.25% (a 45-year low), our Federal Reserve's ability to further stimulate the economy is limited. Going to war without UN support has many conflicting geopolitical ramifications, but the financial one is clear: the US must pay for the majority of the war effort itself. The cost of the war (not including the rebuilding of Iraq) is conservatively estimated at $80 billion. While Congress will probably approve this expenditure in a waterfall of patriotism, the aggregate cost of the war may be detrimental to the strength of US $ and the future stability of our economy.

While all of us have been glued to the TV watched our successes in Iraq, the reports of poor economic data, another large-scale corporate fraud (HealthSouth), and lackluster 1st quarter corporate earnings announcements continue. How long will domestic large cap stocks continue to rally?

It is worth noting that during the height of the internet/technology bubble in 1999/2000, investors were told (and they believed) that *corporate earnings did not matter*; the new economy had a "new metric" of equity valuation. Unfortunately, but not surprisingly, this turned out to be wrong.

Today, investors are being asked to believe the large and growing Federal budget deficits do not matter. The recent rally in the domestic stock market implies that there are investors who believe the growing deficits are not relevant. Is a "new metric" for economic theory afoot?

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With the geopolitical and economic picture so unclear, investment portfolio diversification has never been more important. As we have discussed, our current market outlook includes the possibility of a weaker US $ and greater domestic inflation, as well as the likelihood that US interest rates may not decrease significantly from these levels. The ramifications of these possible scenarios for the stock and bond markets are significant and are reflected in the composition and selection of asset class investments in our portfolios.

We were fortunate to make our first appearance in the February 26, 2003 issue of the *Wall Street Journal* in the Getting Going column by Jonathan Clements. It is gratifying to be mentioned in the Getting Going column in the WSJ as I believe is one of the few islands in the financial press devoted to the individual investor that is devoid of marketing hype and trend-following so common in popular investment journalism.

I consider Mr. **C**lements the "**C**" in what I call the "**ABC's**" of investment journalism. Joining Mr. Clements this alphabetic stable of investment writers are: Dr. Clifford **A**sness, PhD, a publishing academic and founding partner of AQR Capital (www.aqrcapital.com) a hedge fund in New York, and Dr. William **B**ernstein, MD, author of the landmark investment books: *The Intelligent Asset Allocator* and *The Four Pillars of Investing*. These three guys are the only regularly published author's in the field whose writings I encourage our clients to read consistently.

I'm told Jonathan's new book, *You've Lost It, Now What? How to Beat the Bear Market and Still Retire on Time* is flying off the shelves.

For those readers who would like to know us better, we have introduced a basic and advanced Frequently Asked Questions (FAQs) (FAQsII) section in the Investment Topics section of our website (www.thelamgroup.com) to address questions prospective clients may have about our Firm.

Nelson J. Lam
The Lam Group, Inc.
April 16, 2003

Archives for The Lam Group Newsletter are available at our website: www.thelamgroup.com

Asset Class Investment Results:
All portfolios constructed and managed by The Lam Group are designed for an individual client's specific risk tolerances, income requirements and investment horizon. Our "value-added" approach includes the design of a client-specific asset allocation plan, the research and selection of the most cost efficient and appropriate asset class investments for a client's specific investment policy, and the monitoring and annual rebalancing of the portfolio to optimize return, manage risk and minimize taxes.

As different clients have different goals, risk profiles and investment horizons, it is not useful to publish a track record of specifically managed portfolios. The investment performance data below illustrate the returns of some of the actual mutual funds utilized by The Lam Group for specific asset class allocations in the construction of our client's portfolios.

Asset Class Category	1Q2003	12 mo.	3 Year Annualized	Correlation w/ S&P 500
Domestic Total Equity Market				
-Wilshire 5000 (Total Dom. Eq. Market)	- 3.08%	- 24.03%	- 16.30%	+ 0.98
US Total Market Fund	- 3.14%	- 24.18%	- 16.27%	+ 0.98
Domestic Large Cap Stocks				
-S&P 500	- 3.15%	- 24.75%	- 16.09%	+ 1.00
Domestic Large Cap Value Fund	- 5.62%	- 24.67%	- 1.64%	+ 0.76
Domestic Small Cap Stocks				
-CRSP 6 -10	- 4.08%	- 25.31%	- 9.66%	+ 0.74
-Russell 2000	- 4.49%	- 26.96%	- 11.00%	+ 0.71
Domestic Small Cap Fund	- 4.93%	- 26.68%	- 7.32%	+ 0.73
Domestic Small Cap Value Fund	- 7.61%	- 24.74%	+ 0.99%	+ 0.68
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	+ 1.22%	- 3.23%	+ 14.45%	+ 0.18
REIT Fund	+ 1.61%	- 1.86%	+ 14.42%	+ 0.17
Domestic Bonds				
-Lehman Aggregate Bond Index	+ 1.39%	+ 11.69%	+ 9.81%	- 0.36
US TIPS Fund	+ 2.19%	+ 17.99%	+ 12.23%	- 0.33
Intermediate Domestic Bond Fund	+ 2.08%	+ 11.77%	+ 10.54%	- 0.27
Short Duration Global Fund	+ 0.67%	+ 5.87%	+ 5.97%	- 0.46
International (non-$) Bonds				
-Salomon Non-$ World Govt	+ 3.73%	+ 28.95%	+ 6.34%	- 0.14
Non-$ Bond Fund	+ 4.55%	+ 29.95%	+ 6.50%	- 0.08
International Large Cap Stocks				
-MSCI EAFE (in US $, price only)	- 8.21%	- 23.59%	- 19.54%	+ 0.85
International Large Value Fund	- 7.61%	- 19.53%	- 9.01%	+ 0.71
International Small Cap Stocks				
-MSCI Small Cap EAFE (in US $, px only)	- 3.57%	- 17.08%	- 13.56%	+ 0.63
International Small Cap Fund	- 0.14%	- 5.10%	- 6.06%	+ 0.53
International Small Cap Value Fund	- 0.14%	- 2.08%	- 0.70%	+ 0.50

* 3 yr correlation using monthly data

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