The Lam Group

Investment Management

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The Big Picture – Follow the Job Growth

Despite the impressive, albeit liquidity-driven rally in the stock market, many people in the US continue to be unemployed or vastly underemployed, and the picture for improvement on the job front is cloudy at best.

It is frequently discussed by economists and economic pundits that *there cannot be a sustained economic recovery in the US without job growth*. On this point, there is little disagreement. Some argue that with growing unemployment, the economic recovery in the US will be elusive.

With US corporations still managing earnings from the expense side (cutting costs, employees) rather than revenue side (growing sales), the earnings growth that the stock market is feasting on is not sustainable. Over the last few years, corporate downsizing and expense rationalization resulted in a smaller, more productive workplace. A negative by-product of increased corporate productivity is the loss of domestic skilled jobs. This loss of jobs is exacerbated by the absence of top-line corporate revenue growth. While some of these lost jobs are eliminated, many jobs are being exported overseas where labor costs are low and workforce skill is improving.

As recently discussed in *The New York Times*, the number of US manufacturing, services, and more recently, research, technical and engineering jobs, getting exported overseas is growing every day. Anecdotal evidence of this is everywhere; anyone who has called the toll-free technical support number for a technology-oriented company (Dell for example) has experienced a competent, articulate representative, speaking to you from offices in India. These are jobs that used to be here.

While it is not clear what our Administration can or will do to stem the growing exportation of skilled jobs to developing countries, one concept is clear and consistent from an investment standpoint:

Significant job growth can create sustained economic growth.

As the skilled labor in the emerging markets countries is less expensive than it is in the US, the potential for further job growth in developing countries is real and is likely to continue on its current trajectory. As a consequence, the economic prospects for these emerging markets countries are bright and improving. In order to stay competitive globally, US corporations will have to hire the best skilled labor at the best price. This may mean the loss of more US jobs.

With the prospect of sustained economic growth fueled by increase employment, it makes sense to have some level of portfolio exposure to emerging market economies. While the emerging markets

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(equity and debt) have their own unique risks, these asset classes can increase return and reduce overall risk when included in a global investment portfolio.

Market Perspective: Who Hasn't Refinanced?

Like many homeowners, I refinanced my mortgage earlier this year. And why not? With interest rates reaching a 45-year low, for those who expect to live in their homes for the foreseeable future, it makes good financial sense to lock in as low a mortgage rate as possible for as long a term as a lender will lend. *Borrow long when rates are low.* Homeowners do it, corporations do too.

Why then, has the US Treasury not issued 30-year bonds since October 2001? With the large and growing budget deficits borne from the domestic and international events subsequent to 9/11, the amount the United States Government needs to borrow money has never been greater; why not lock in "long and low"? Was a window of opportunity been missed when interest rates hit their low in May 2003?

As taxpayers (and effectively shareholders) of the United States, shouldn't we question why our government has not locked in long-term financing when it was available? Why has the US Treasury not done what US homeowners and global corporations have done in record numbers?

Why indeed. When the US Treasury unexpectedly announced that it was discontinuing the issuance of 30-year bonds in October 2001, long interest rates plummeted as demand for the remaining 30-year treasuries outstripped the supply. By discontinuing the issuance of the benchmark 30-year bond, the US Treasury in effect artificially lowered long interest rates to stimulate a weak and uncertain post 9/11 economy. As we have seen, homeowners and corporate borrowers have taken advantage of the US Treasury's largesse in the record levels of mortgage refinancing and corporate debt issuance over this time period.

This "stealth" stimulus contributed by the US Treasury, combined with stimulative effects of the Federal Reserve maintaining short interest rates at 1%, have conspired to send the stock market back to dizzying heights. While the environment for stocks is almost festive; the behavior of the Fed and the Treasury seems *desperately stimulative*.

Yet how is the US economy doing? That is a hard question to answer, however, if the economic recovery cheerleaders at media outlets like *CNBC* and *Barron's* are to be believed, a sustained economy recovery is underway despite any real evidence of the requisite 1) growth in domestic employment, 2) increase in top-line corporate revenue and 3) return of new (not replacement) capital spending.

If the economy is doing so well, why are the Federal Reserve and the US Treasury trying so hard to hold short and long rates down? It is troubling that the US Treasury is borrowing record-breaking sums to finance our growing deficits and *is not using its most effective and powerful financing instrument: the long bond*. It is also troubling the US Federal Reserve is lending money to the financial system at a historically low rate of 1%. One branch of the federal government lending at the lowest rates in 45 years, while another branch is borrowing more than it ever has. If this policy of auto-gratification seems perverse, it probably is.

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As a result of these artificially low interest rates, debt levels for personal, corporate and government balance sheets have grown to record levels. It is worth noting that highly indebted entities are most vulnerable to deflationary pressures. Could the fear of deflation be why the Fed and the Treasury are so busy?

So to answer the original question, “Who Hasn’t Refinanced?”, the answer may be: those who cannot. While the issuance of longer Treasury debt would give our government a more stable long-term capital structure (locking in “long and low”) the omission of the 30-year financing alternative may indicate that lower interest rates in the near-term is more important to our economy than securing once-in-a-lifetime long interest rate financing opportunities.

We are defined by the decisions we make. It is worth noting that while cheap money can be highly simulative, it can come with dangerous (inflationary) consequences.

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The run up in the securities markets this year have been impressive. Domestically, the results are pretty good.

Index	Asset Class	3Q 2003	YTD 2003
S&P 500	Domestic Large Cap Equity	+ 2.65%	+14.71%
Russell 2000	Domestic Small Cap Equity	+ 9.07%	+28.57%
Nasdaq 100 Index	Domestic Growth Equity	+ 8.25%	+33.03%
Lehman Aggregate Bond	Domestic Investment Grade Bonds	- 0.14%	+ 3.77%
CSFB High Yield Bond	Domestic Non-Invest. Grade Bonds	+ 3.04%	+20.88%

However, by focusing on only the domestic markets, you may not know what you are missing:

Index	Asset Class	3Q 2003	YTD 2003
MSCI EAFE	Intl Developed Large Cap Equity	+ 8.31%	+18.37%
MSCI EAFE Small Cap	Intl Developed Small Cap Equity	+15.99%	+38.67%
MSCI Emerging Markets	Intl Emerging Countries Equity	+13.51%	+29.29%
SB Non-$ World Govt Bond	Intl Developed Govt Bonds	+ 2.75%	+11.07%
J.P. Morgan EMB+	Intl Emerging Countries Debt	+ 2.42%	+22.37%

In virtually every category, the international developed and emerging markets have outperformed the corresponding domestic market asset class. From a portfolio performance and diversification standpoint, the importance of including non-$ asset classes in an aggregate investment portfolio cannot be overemphasized.

As we stated at the beginning of the year, we continue to believe over the intermediate-to-longer term, the US dollar is poised to weaken and the factors that may cause the US Treasury yield curve to steepen (such continued deficit spending, and/or the reintroduction of the long bond) are worthy of investor attention. These issues are important considerations in evaluating the global risks in the equity and fixed income markets.

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We continue to approach the markets and our portfolios with a disciplined and consistent asset allocation framework. At this time, while all investment asset classes seem high relative to the economic environment, it is important to remember that as investors, we cannot have an expectation of positive return without assuming some level of risk. The investment risks we take for ourselves and our clients are purposeful, yet mitigated by the diversifying effects of combining various asset classes with low relative correlations in our global portfolios.

For those readers who would like to know us better, our website (www.thelamgroup.com) has added several new features including a Frequently Asked Questions section to address questions prospective clients may have about our Firm.

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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	3Q2003	YTD	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 (Total Dom. Eq. Market)	+3.70%	+17.10%	- 9.53%	+ 0.99
US Total Market Fund	+3.60%	+16.86%	- 9.60%	+ 0.99
Domestic Large Cap Stocks				
-S&P 500	+2.65%	+14.71%	-10.13%	+ 1.00
Domestic Large Cap Value Fund	+3.82%	+15.38%	+ 3.84%	+ 0.85
Domestic Small Cap Stocks				
-CRSP 6 -10	N/A	N/A	N/A	N/A
-Russell 2000	+ 9.07%	+28.57%	- 0.82%	+ 0.84
Domestic Small Cap Fund	+ 9.90%	+31.36%	+ 3.49%	+ 0.85
Domestic Small Cap Value Fund	+11.66%	+32.08%	+12.95%	+ 0.75
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	+9.93%	+24.73%	+14.96%	+ 0.35
REIT Fund	+9.50%	+24.39%	+15.08%	+ 0.34
Domestic Bonds				
-Lehman Aggregate Bond Index	- 0.14%	+ 3.77%	+ 8.94%	- 0.41
US TIPS Fund	+ 0.75%	+ 6.68%	+12.08%	- 0.34
Intermediate Domestic Bond Fund	- 0.18%	+ 4.78%	+ 9.79%	- 0.34
Short Duration Global Fund	+ 0.34%	+ 1.83%	+ 5.06%	- 0.50
International (non-$) Bonds				
-Salomon Non-$ World Govt	+ 2.75%	+11.07%	+10.77%	- 0.20
Non-$ Bond Fund	+ 2.76%	+13.09%	+11.30%	- 0.10
International Small Cap Stocks				
-MSCI Small Cap EAFE (in US $, px only)	+15.99%	+38.67%	+ 0.00%	+ 0.67
International Small Cap Fund	+14.95%	+41.80%	+ 7.42%	+ 0.59
International Small Cap Value Fund	+16.03%	+47.55%	+13.79%	+ 0.56
Emerging Markets				
-MSCI Emerging Markets Free	+13.51%	+29.29%	- 0.73%	+ 0.83
Emerging Markets Value Fund	+14.39%	+42.84%	+ 7.15 %	+ 0.81

* 3 yr correlation using monthly data

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