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The Big Picture

Part I: That 70's Show

To be a well-informed investor, it is important to have an appreciation of market history and an understanding of global customs. With this in mind, consider the following historical perspective:

Before August 1971, the US dollar was pegged to the value of gold (at $35/ounce). Pegging, or fixing the price of a commodity like gold versus the US dollar meant that if the value of gold rose (or fell), an institution (in this case, our central bank, the US Federal Reserve), would have to buy (or sell) US dollars to keep the relationship between gold and the US dollar fixed at $35/ounce. For this reason, the US dollar was then known as the gold standard.

In the early 70's, as President Nixon prepared for his re-election campaign, his Administration significantly increased government/deficit spending to ignite the economy and the financial markets, and at the same time, the Federal Reserve dropped interest rates dramatically to further stimulate the economy. The US Government was printing money.

With so much US currency being printed, foreign central banks began to sell their devalued US dollars to buy gold. The global demand for gold increased, thereby requiring our central bank (the Fed) to buy US dollars on the open market to maintain the $35/ounce relationship.

Requiring the Fed to purchase US dollars in the open market was in effect, a potential tightening of US monetary policy, which at that time would have put a damper on the economy. Instead of buying dollars to maintain its $35/ounce relationship with gold, in August of 1971, the Nixon Administration severed the fixed relationship between gold and the US dollar, allowing the prices of each to be driven by free market forces. As a consequence, the price of gold soared and the value of the US dollar plunged further.

At this point, it is worth noting that the global market convention for buying and selling oil is based on a system entirely denominated in US dollars.

How can an oil sheik stay chic if the currency that buys his oil devalues dramatically?

The answer is to raise the price of oil dramatically. In the mid 1970s, there was a significant energy crisis in the US driven by soaring oil prices. It is amusing when historians puzzle over the domestic energy crisis and the subsequent run-away inflation that occurred during this period without mentioning the relationship between the value of the US dollar and the price of oil.

Part II: The China Syndrome
Today we have a similar global situation with similar influences, but different players.

As President Bush prepares for his re-election campaign, his Administration has significantly increased government/deficit spending to ignite the economy and the financial markets and the Federal Reserve has dropped interest rates dramatically to further stimulate the economy.
The US Government is printing money.

One of our current Administration's biggest challenges in this re-election year is the growing domestic unemployment situation. Many jobs (skilled and unskilled) have been exported to emerging countries such as China, whose labor costs are significantly lower than ours and whose currency (the yuan) gives goods manufactured in China a global price advantage due to the yuan being pegged/fixed to the US dollar at an exchange rate of 8.3 yuan/dollar. While there is little that can be done about the lower standard-of-living that workers in emerging countries like China are willing to endure to attract economic growth, the advantage China enjoys by pegging its currency to the US dollar is problematic for the US economy.

As China exports more than it imports, its current account balance is positive and growing due to the strong and growing demand for yuan. At the most basic level, this means in order to buy Chinese goods and services, global importers have to sell their local currency (US $, euros, yen, etc.) to buy yuan to pay for their Chinese purchases. Because the Yuan is pegged/fixed rate to the US dollar, an entity (in this case China's central bank) must constantly buy US dollars to keep the relationship fixed at 8.3 yuan/dollar. China buys billions of US dollars annually. This fixed foreign exchange rate gives Chinese manufacturers/exporters an unfair advantage in global trade.

What does China do with all those US dollars?

China uses its US dollars to purchase US Treasury bills, notes, and bonds. They are one of the largest foreign buyers of US government debt. Our Treasury Department is becoming increasingly reliant on foreign buyers of US Treasury securities to finance our growing budget deficit. China buys billions of US Treasuries annually, and foreign investment such as this is one of the reasons interest rates have stayed low even though the absolute level of US Treasury borrowing has skyrocketed.

While President Bush and Secretary of the Treasury Snow have stated publicly that they support a strong US dollar policy, they have also said they believe in free trade with respect to currency markets. Clearly they cannot have both (sort of like military intelligence).

With an election year upon us, the growing domestic unemployment situation will be a key issue. To that end, the Bush Administration feels China cannot continue to enjoy the dual advantages of having cheaper labor AND a foreign exchange advantage as a global trade competitor. One way to make China a less attractive labor and manufacturing alternative for US companies is to relax (or sever) the fixed relationship between the Chinese yuan and the US dollar. While China, for obvious reasons is against de-linking its currency to the US dollar, any movement towards free markets with respect to the yuan and the dollar will result in the yuan strengthening at the expense of the dollar.

A more market-driven foreign exchange rate for the yuan would have serious ramifications for the US economy. In the short-term, more jobs would remain on our shores and US companies that export goods and services would benefit from a weaker US dollar. At the same time, with China buying fewer US dollars (and, as a consequence, fewer US Treasury securities), over the longer term, the US dollar will become worth less and interest rates on US Treasury securities will have to rise (to attract replacement buyers for the Chinese).

It is worth noting again that the global market convention for buying and selling oil is based on a system entirely denominated in US dollars. A weaker US dollar, exacerbated by our desire improve exports and to keep jobs on shore, will put pressure on our oil-producing friends to raise prices in order to maintain a lifestyle (a sheik needs to stay chic) to the detriment of ours.

The combination of a weak currency, growing budget deficits and rising commodity prices is as good a recipe for inflation we have seen since the 1970s.

Part III: Clear and Present Danger

In 2003, the US dollar fell over 16% versus the euro and almost 10% versus the yen.

Our victory in Iraq and the capture of Saddam Hussein have not produced lower oil prices as some have predicted. In fact, the price of oil rose over 4% in 2003. This is not a criticism, it is merely an observation. *Is the fall in the value of the US dollar and the increase in the price of oil a coincidence?* As Yoga Berra once said,

"It's déjà vu all over again."

While some might feel this discussion of weak currency, foreign/emerging markets growth at the expense of the domestic economy, and impending inflation is depressing, it is not. With a global portfolio outlook, an appreciation of market history and an understanding of global customs present meaningful opportunities if we consider the growing importance of non-US dollar asset classes (such as international and emerging markets equity and debt) and inflation-linked investments (such as commodities, TIPS and commercial real estate) in the context of an aggregate investment portfolio.

In this sense, when the global economic environment gives you lemons, the best course of action for global investors is to make lemonade. With the value of the Chinese yuan currently fixed to the value of the US dollar, this lemonade may be *Made in China*.

Market Perspective: It's All Relative…
2003 was the first year in the new millennium that domestic equities had a) a positive return and b) outperformed domestic bonds. It is cause for celebration.

Domestic Index	Asset Class	4Q 2003*	2003*
S&P 500	Domestic Large Cap Equity	+12.17%	+28.67%
Russell 2000	Domestic Small Cap Equity	+14.53%	+47.25%
Nasdaq 100 Index	Domestic Growth Equity	+12.59%	+49.12%
Lehman Aggregate Bond	Domestic Investment Grade Bonds	+ 0.32%	+ 4.11%
CSFB High Yield Bond	Domestic Non-Invest.Grade Bonds	+ 5.83%	+27.93%

However, by focusing only on the domestic markets, many investors are missing the party:

International Index	Asset Class	4Q 2003*	2003*
MSCI EAFE	Intl Developed Large Cap Equity	+17.08%	+38.59%
MSCI EAFE Small Cap	Intl Developed Small Cap Equity	+13.77%	+57.76%
MSCI Emerging Markets	Intl Emerging Countries Equity	+17.25%	+51.59%
SB Non-$ World Govt Bond	Intl Developed Govt Bonds	+ 6.71%	+18.52%
J.P. Morgan EMBIG	Intl Emerging Countries Debt	+ 4.71%	+25.65%

* index data provided by Morningstar, PIMCO and MSCI.

In 2003, the international developed and emerging markets have outperformed the corresponding domestic market asset class in virtually every category. From a portfolio performance and diversification standpoint, the importance of including some level of non-$ asset classes in an aggregate investment portfolio cannot be overemphasized.

As we stated at this time last 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 as continued deficit spending, and/or the reintroduction of the long bond) are worthy of investor attention. These issues continue to be important considerations in evaluating the global risks in the equity and fixed income markets.

2004 Investment Outlook
The market tailwind of declining US interest rates is over. Recognition of this global milestone is important for all investment asset classes. It is possible that the tailwind of declining interest rates could be replaced by a declining US dollar tailwind. If so, having a meaningful allocation to non-US asset classes will be as important in 2004 as it was in 2003.

Our investment outlook for 2004 includes the following predictions, strategies, ideas and biases:

General:
- The US dollar will continue to weaken against the currencies of developed countries.
- Inflation, driven by a weaker US dollar and higher commodities prices, may become a more meaningful concern for US investors.
- Increasing domestic unemployment will continue to be damaging to the US economy.

Bonds:

- While the Fed will maintain its current position on short interest rates for most, if not all, of 2004, long interest rates are likely to rise as a consequence of the growing US budget deficit and the weakening US dollar. This should cause the US Treasury yield curve to steepen.
- A steep yield curve implies inflationary pressures. As inflation is the enemy of traditional fixed income products (particularly those of longer duration), it is important to include TIPS and other inflation-linked investments in a fixed income portfolio allocation.
- It is possible that the US Treasury reintroduces the 30-year bond.
- With domestic interest rates at current levels, there is little upside to owning domestic investment grade bonds, particularly those which have longer maturities/duration. This asset class has considerable downside from both a credit and interest rate perspective.
- Favored fixed income sectors include:
  - non-$ bonds, emerging markets debt, TIPS and inflation-linked (commodities) products, and short-duration domestic bonds (high-quality municipal bonds)
- Fixed income sectors to avoid include:
  - traditional long-duration bonds in all the domestic investment-grade sectors.

Stocks:

- As it is our belief the US dollar will continue to weaken against developed market currencies, it is possible that international stocks will continue to outperform domestic stocks, particularly in the small cap asset class.
- The emerging markets equity asset class should continue to benefit from their lower labor costs and growing economies.
- Domestic large cap stocks will have to show real top-line earnings growth to sustain their current lofty valuations.
- As growth-oriented stocks outperformed value-oriented stocks in 2003, it is possible that value outperforms growth in 2004.
- Small cap stocks will outperform large cap stocks in the long run.

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.

The Lam Group
Over the last year, The Lam Group has grown to over $50 million in assets under management and is now an SEC-registered investment advisory firm. We have clients in Oregon, Washington State, California, New York and New Jersey and we are grateful for the trust our clients have placed in our young firm and their belief in our asset allocation-based investment approach.

We are accepting a limited number of new clients for 2004. For those newsletter 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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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	4Q2003	2003	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 (Total Dom. Eq. Market)	+12.41%	+31.63%	- 2.45%	+ 1.00
US Total Market Fund	+12.40%	+31.35%	- 2.59%	+ 1.00
Domestic Large Cap Stocks				
-S&P 500	+12.17%	+28.67%	- 4.05%	+ 1.00
Domestic Large Cap Value Fund	+16.50%	+34.42%	+ 5.90%	+ 0.89
Domestic Small Cap Stocks				
-CRSP 6 -10	+15.65%	+58.46%	+14.30%	+ 0.85
-Russell 2000	+14.53%	+47.25%	+ 6.27%	+ 0.85
Domestic Small Cap Fund	+15.32%	+51.49%	+11.34%	+ 0.85
Domestic Small Cap Value Fund	+20.69%	+59.40%	+21.05%	+ 0.77
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	+9.08%	+36.06%	+16.56%	+ 0.40
REIT Fund	+9.01%	+35.59%	+16.92%	+ 0.38
Domestic Bonds				
-Lehman Aggregate Bond Index	+ 0.32%	+ 4.11%	+ 7.57%	- 0.41
US TIPS Fund	+ 1.52%	+ 8.50%	+11.35%	- 0.33
Intermediate Domestic Bond Fund	+ 0.75%	+ 5.56%	+ 8.40%	- 0.34
Short Duration Global Fund	+ 0.09%	+ 1.91%	+ 4.41%	- 0.51
International (non-$) Bonds				
-Salomon Non-$ World Govt	+ 6.71%	+18.52%	+11.73%	- 0.15
Non-$ Bond Fund	+ 6.60%	+20.56%	+12.02%	- 0.07
International Small Cap Stocks				
-MSCI Small Cap EAFE (in US $, px only)	+13.77%	+57.76%	+ 6.93%	+ 0.72
International Small Cap Fund	+11.97%	+58.78%	+13.13%	+ 0.64
International Small Cap Value Fund	+12.83%	+66.48%	+18.89%	+ 0.62
Emerging Markets				
-MSCI Emerging Markets Free	+17.25%	+51.59%	+ 9.88%	+ 0.85
Emerging Markets Value Fund	+23.36%	+76.21%	+19.70%	+ 0.83

* 3 yr correlation using monthly data