The Lam Group Newsletter Vol. 4, No. 3
Third Quarter 2004

The Big Picture: Purchasing Power and the Deficits

Regardless of who wins the US Presidential election in November, voters on both sides of the aisle will have to contend with growing deficits (budget and trade), whose ramifications include the further weakening the US dollar and the consequential loss of our currency's global purchasing power. The winner on November 2nd has a challenging job ahead of him.

While the large and growing US budget deficit is frequently discussed as being the most dangerous issue facing our economy, it is merely a symptom of a much greater problem:

How strong is our purchasing power?

In our daily lives, everyone knows someone who spends or lives beyond their means, is always borrowing money, or some unattractive combination of both. People who live this way are dependent on others to achieve their day-to-day lifestyle. This "borrower's" lifestyle is sustainable only as long as someone is willing to lend. For these people, while it is always nice to borrow from a friend, after a while, most *chronic borrowers* don't care who they borrow from; they just care how much they can borrow, how quickly, and at what rate. Aside from borrowing too much, the biggest danger to the chronic borrower is to become too dependent on a limited number of lenders.

Eventually, like all financial transactions, large-scale borrowing becomes an issue of risk and return. The willingness to lend becomes dependent on the amount of risk a lender already has, and the amount of incremental risk the lender is willing to take.

With the ongoing military operations in Iraq and our domestic challenges at home (including the fragile social security system, rising educational and healthcare costs, and the economic viability of long-term tax cuts), the United States is spending more than it is making, and financing the growing shortfall by issuing debt (US Treasury Securities).

As a country, we have become a chronic borrower.

In recent years, we have gone beyond borrowing from our friends to borrowing from whoever will lend to us on the most favorable terms. Today, over 40% of US Treasury debt is now owned by foreign investors and central banks.

Issuing debt is another way of "printing" money. With all our global borrowing/debt issuance, it is possible that at some point, investors of US Treasury securities may demand more yield (or else look to other less risky investments) to accept the growing universe of US Treasury debt and the attendant risks that come with lending more to a chronic borrower. The consequence of printing unlimited amounts of money is simple: the value of our currency becomes worth less.

A weakening currency means a loss of global purchasing power

As China exports more than it imports, their current account balance is positive and growing due to the strong and growing global demand for its currency (the yuan). At the same time, because the yuan is pegged/fixed to the US dollar, an entity (in this case China's central bank) must constantly buy US dollars to keep the relationship fixed at the 8.3 yuan/dollar ratio. China buys billions of US dollars annually and invests these dollars in US Treasury securities.

China is quickly becoming one of our largest lenders.

In many ways, the fixed foreign exchange rate that China enjoys gives its manufacturers and exporters an unfair advantage in global trade. At the same time, the fixed yuan/dollar relationship requires that China buy billions of US Treasuries annually, and this is one of the reasons interest rates in the US have stayed low even though the absolute level of US Treasury borrowing has skyrocketed.

What if China unpegged the yuan from the dollar?

In a global marketplace, is unlikely that the rest of the world will continue to allow China to enjoy the trade advantages it has by pegging its currency to ours. As China's economy becomes more diversified (trading with more countries) and sophisticated (exporting as well as consuming), it is likely its dependence on exporting goods to the US will become a smaller part of its growing commerce.

Any movement towards free markets with respect to the yuan and the dollar will likely result in the yuan strengthening at the expense of the dollar. If the 8.3 to 1 peg is loosened or severed, China will need to buy fewer US dollars and, as a consequence, lower its demand for US Treasury securities. If that happens, it is likely the US dollar will decline in value (fewer buyers) and interest rates on US Treasury securities may need to rise (to attract replacement buyers for the Chinese).

It is important to remember that the global market convention for buying and selling oil is based on a system entirely denominated in US dollars. If China's currency strengthens relative to ours and its economy is trying to buy the same barrels of oil we are, there will be upwards pressure on the price of oil. Furthermore, as it is probable that China's demand for oil (and other commodities) will increase rather than decrease in the future, this demand will add to global inflationary pressures.

The correlation of a weakening US dollar against other free-market currencies and a rise in the price of oil has already been demonstrated over the past two years, and this relationship is easy to explain. As oil is paid for in US dollars and our chronic borrower behavior has caused our currency to weaken, oil-producing nations need to adjust prices (upward) to protect/maintain their profit margins. Who can fault a business owner from making a sound business decision?

Mark Twain once said:

History doesn't repeat itself, but it does rhyme.

With Mr. Twain's wisdom in mind, the current issues of chronic borrowing, the declining value of our currency, and their combined effects on our country's global purchasing power are poetically reminiscent of the disco era.

As investors, this global perspective requires a broader portfolio focus and demands asset class allocations that include non-US dollar (equity and debt) exposures, as well as exposures to real assets such as commodities, TIPS, and commercial real estate. These non-US dollar and real asset exposures are important and permanent allocations within a diversified investment portfolio that will provide a hedge against the possibility (likelihood) of diminished US currency purchasing power and the consequential global inflationary pressures.

In contrast, it is important to realize that too narrow an investment focus, especially a portfolio strategy that includes only domestic stocks and bonds, may not be diversified enough and could negatively expose a long-term investor to the potential loss of purchasing power in the context of increasingly global markets and economies.

The Lam Group
At the beginning of 2004, many investors thought that interest rates were headed higher and that the domestic fixed income asset class and other interest-rate-sensitive asset classes (such as REITs) should be avoided. As of 9/30/04, it is worth noting that not only have domestic bonds outperformed domestic stocks for 2004 YTD, but interest-rate-sensitive asset classes (such as REITs) have outperformed them all. Is this a trend?

Asset Class Category	YTD 2004
-S&P 500 Index	+ 1.51%
-Wilshire 5000 Index (Total Dom. Eq. Market)	+ 2.08%
-Lehman Aggregate Bond Index	+ 3.35%
-Wilshire REIT Index	+14.68%

Probably not. When managing investment portfolios, it is important to realize that it is impossible to predict the future when it comes to markets and investment returns. More importantly, it is essential not to "chase" recent investment performance at the asset class or manager level. *Anyone who tells you differently is likely to be trying to sell you something.*

What is possible, however, is to formulate a *portfolio asset allocation plan* that realistically reflects an investor's expectations for return, tempered by his/her capacity for risk. To do this, multiple asset classes with low relative correlation should be used to insure adequate diversification, which, in turn, should enhance returns while lowering the aggregate risk of the portfolio.

Most importantly, it is essential to maintain the integrity of the original asset allocation plan by rebalancing the portfolio periodically to capture returns in the asset classes that have done well, and to increase the possibility of positive returns in the asset classes that haven't. Disciplined portfolio rebalancing preserves a portfolio's intended risk profile and is an elegant approach to "buy low and sell high" without trying to time the market.

In September 2004, we decreased our exposure to the REIT asset class for most of our long-time investment management clients and recommended reducing REIT asset class exposure to all of our investment consulting clients. With the REIT's extraordinary performance in 2004 (and every year since 1999), its exposure within a diversified portfolio for many clients had grown well beyond initial portfolio plan allocations. While we have no powers to predict the future returns of the REIT asset class (it may continue to go up), as many of our client's exposure to this asset class have well exceeded their *portfolio asset allocation plan*, we have adjusted these exposures accordingly.

At The Lam Group, with our asset allocation portfolio management approach, we try to minimize our reliance on luck, and as a consequence, take no credit for it. We design globally diversified portfolios that take into consideration a client's risk profile, time horizon, and tax position. Central to our investment strategy is tax-efficiency, achieved through tax gain/loss harvesting, and risk management using disciplined portfolio rebalancing. All portfolios are constructed with distinct asset classes that have low relative correlations and we employ asset class managers with the lowest cost structure (no hidden fees or expenses).

The Lam Group is an independent, fee-only, SEC registered investment advisory firm that does not suffer from the inherent conflicts of interest so prevalent in the investment management business today. For those readers who would like to know us better, our website (www.thelamgroup.com) has added several features, including a Frequently Asked Questions section to address questions prospective clients may have about our firm.

Nelson J. Lam
The Lam Group, Inc.
P.O. Box 850
Lake Oswego, OR 97034
October 15, 2004

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 investment management approach includes the design of a customized asset allocation plan, the research and selection of the most appropriate and cost-effective asset class investments for the client's specific investment policy, and the on-going monitoring and disciplined rebalancing of the aggregate 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 investment portfolios we manage.

Equity Asset Class Category	**3Q2004**	**YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	- 1.78%	+ 2.08%	+ 6.12%	+0.99
US Total Market Fund	- 1.82%	+ 2.00%	+ 5.95%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	- 1.87%	+ 1.51%	+ 4.04%	+1.00
Domestic Large Cap Value Fund	- 0.28%	+ 5.49%	+10.52%	+0.93
Domestic Small Cap Stocks				
-CRSP 6 -10 Index				
-Russell 2000 Index	- 2.85%	+ 3.71%	+13.71%	+0.82
Domestic Small Cap Value Fund	- 2.15%	+ 8.96%	+23.63%	+0.76
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	+ 8.20%	+14.68%	+19.24%	+0.32
REIT Fund	+ 8.04%	+14.35%	+19.03%	+0.31
Real Estate Fund	+ 7.01%	+14.92%	+20.22%	+0.50
International Large Cap Stocks				
-MSCI EAFE Index	- 0.28%	+ 4.27%	+ 9.12%	+0.88
International Large Cap Value Fund	+ 0.63%	+10.06%	+16.33%	+0.81
International Small Cap Stocks				
-MSCI Small Cap EAFE Index (in US $, px only)	- 2.04%	+ 9.34%	+18.28%	+0.67
International Small Cap Value Fund	+ 0.30%	+14.15%	+26.97%	+0.55
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	+ 7.39%	+ 4.83%	+22.91%	+0.83
Emerging Markets Value Fund	+12.75%	+14.75%	+35.29%	+0.78

* 3 yr correlation using monthly data

Fixed Income Asset Class Category	3Q2004	YTD	3 Year Annualized	Correlation w/ S&P 500*
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	+ 1.05%	+ 1.00%	+ 3.25%	-0.52
Short Duration Domestic Inv. Gr. Bond Fund	+ 1.31%	+ 1.82%	+ 4.15%	-0.33
Short Duration Domestic Muni Bond Fund	+ 1.62%	+ 0.97%	N/A	N/A
-Lehman Aggregate Bond Index	+ 3.20%	+ 3.35%	+ 5.88%	-0.36
Domestic Investment Grade Bond Fund	+ 3.25%	+ 3.72%	+ 6.54%	-0.27
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	+ 4.50%	+ 7.08%	+14.27%	+0.56
High Yield Bond Fund	+ 1.43%	+ 3.89%	+10.23%	+0.70
Inflation-Linked Bonds				
-Lehman TIPS Index	+ 3.85%	+ 5.80%	+ 9.76%	N/A
TIPS Fund	+ 3.86%	+ 6.07%	+ 9.98%	-0.35
Commodities-Linked Fund	+10.26%	+19.34%	N/A	N/A
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	+ 3.28%	+ 1.36%	+12.06%	-0.20
Non-$ Bond Fund	+ 2.93%	+ 1.26%	+12.82%	-0.14
Emerging Markets Debt				
-JP Morgan EMBI+ Index	+ 9.01%	+ 6.53%	+14.81%	N/A
Emerging Markets Debt Fund	+ 9.61%	+ 6.10%	+21.53%	+0.54

* 3 yr correlation using monthly data