The Lam Group

Investment Management

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The Big Picture: Trick or Treat!

Before the "hurricane sisters" hit, it was clear that Fed Chairman Alan Greenspan had been intent on tightening monetary policy (by raising short-term interest rates) to moderate a growing US economy and to prevent increasing inflationary pressures. Interest rates, by virtue of loose monetary policy, had been kept low for too long and all the attendant problems of too much liquidity were starting to emerge (inflation in the form of rising housing and commodity prices). Mr. Greenspan's initial efforts to tighten monetary policy were slow, deliberate, and well publicized, and while he had a lot of ground to cover (rates had gotten as low as 1%) his "measured" approach was consistent and predictable.

Just when I thought I was out, they pull me back in.

Don Corleone, The Godfather III (1990)

However, with the carnage of Katrina and Rita, Congress has enacted fiscal policies that are expected to provide an estimated $200 billion in rescue, relief, and rebuilding aid to the disaster areas, and consequently, the domestic economy in general. This fiscal relief is a "double whammy" as our government will need to borrow to finance this aid (adding to our continually growing budget deficit), and the addition of $200 billion will provide more liquidity to an economy that is trying to have less. Alan Greenspan's job just got tougher.

To further complicate matters, Mr. Greenspan is scheduled to retire from his position as Chairman of the Federal Reserve in January 2006. In his last three months, it be will interesting to see if he will tighten monetary policy at a more meaningful rate to offset the recent fiscal policy stimulus, or if he will continue on his "measured" pace of interest rate increases and risk the prospect of increasing inflation and all that comes with rising prices.

These will be hard choices. To fight inflation by meaningfully raising interest rates, the Fed Chairman may be putting the stability of the economy at risk.

Regardless of Mr. Greenspan's actions in the next three months, these are the issues that the next Fed Chairman will have to confront. It is worth noting that the majority of candidates for Mr. Greenspan's job are making "hawkish" (inflation-fighting) comments regarding inflation in the media on a daily basis. Perhaps they are auditioning for the role?

Many think the argument for raising US interest rates is pretty strong, and with this directional expectation, the questions for many are "When will rates go up?" and "How quickly?"

It is always worrisome when too many market participants feel the same way. Efficient markets theory tells us that securities prices reflect all available information. That being said, while it is impossible to predict the unexpected, it is always useful to make room for the possibility that unexpected events do occur.

In contrast to the plausible expectation of rising interest rates, another element to consider is that our national human resources, from a military and rescue/relief perspective, are stretched pretty thin. With our commitments in Iraq and our efforts in New Orleans, if there were an act of domestic terrorism, another natural disaster, or an epidemic health emergency (Avian flu), would we have the human resources to readily deploy? At best, the answer is: Maybe.

In times of crisis, the stability of the financial system is often supported by the provision of central bank liquidity (i.e., the Fed lowers rates). Without a meaningful reserve of military and rescue human resources, the Federal Reserve, and its use of monetary policy, may also be our Department of Defense and Federal Emergency Management Agency. Perhaps Alan Greenspan should ask for a raise (in salary).

It is likely that the stimulative effects of the $200 billion hurricane relief will aid the economy in the short-term, yet may increase inflationary pressures in the long-term. While the Fed is expected to continue raising interest rates to slow inflationary pressures, the possibility of a weakening economy and the potential of unexpected events may test the Fed's intentions.

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As the direction of interest rates, like the direction of markets and investment asset classes in general, is impossible to predict, The Lam Group continues to focus on designing and managing globally diversified investment portfolios and managing our client's portfolio risks by employing investment asset classes which have low relative correlation in the context of an aggregate portfolio.

While the destruction caused by Hurricanes Katrina and Rita have been devastating, the effects of these natural disasters have been meaningful from an investment standpoint, and underscore the importance of having a properly diversified investment portfolio. We are pleased with the performance of our balanced portfolio strategies through 3Q 2005. The returns of the real asset and non-US allocations to-date have more than offset the lackluster results of the broad US stock and bond markets.

It is worth noting that October has historically been a volatile month for the markets. Some of this volatility can be attributed to the October 31st year-end for mutual funds for tax purposes. This is important because as mutual funds try to minimize taxable distributions they are required to report at the end of the calendar year, they tend to sell many of their biggest winners and losers in October to maximize the fund's overall tax-efficiency. This tax-motivated selling can add significant volatility to the markets as Halloween approaches.

Consequently, it is essential that October's annual market volatility not obscure the importance of a disciplined asset allocation framework and diversified portfolio approach.

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Investment Management

The Lam Group is an independent, fee-only, SEC-registered investment advisory firm with over $145 million in assets under management and clients in Oregon, Washington State, California, Connecticut, New York, and New Jersey. We offer both investment management and portfolio consulting services for taxable investors, family offices, foundations, and endowments.

Our asset allocation approach utilizes a highly analytical process to determine the appropriate combination of asset classes to build investment portfolios and strategies that realistically and optimally reflect the needs, risk tolerances, and investment horizons of our clients.

The Lam Group is now accepting new clients on a referral basis only.

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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 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	**3Q2005**	**YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*+ 3.89%*	*+ 3.90%*	*+ 18.43%*	*+0.99*
US Total Market Fund	+ 4.01%	+ 3.73%	+ 18.23%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	*+ 3.60%*	*+ 2.77%*	*+16.71%*	*+1.00*
Domestic Large Cap Value Fund	+ 5.69%	+ 8.80%	+22.46%	+0.92
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*+ 5.88%*	*+ 4.43%*	*+29.09%*	*+0.85*
-Russell 2000 Index	*+ 4.69%*	*+ 3.38%*	*+24.12%*	*+0.83*
Domestic Small Cap Value Fund	+ 6.17%	+ 6.20%	+31.17%	+0.80
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*+ 4.09%*	*+11.21%*	*+26.51%*	*+0.24*
REIT Fund	+ 3.75%	+10.76%	+25.86%	+0.25
Real Estate Fund	+ 0.85%	+10.65%	+26.14%	+0.45
International Large Cap Stocks				
-MSCI EAFE Index	*+10.38%*	*+ 9.08%*	*+24.61%*	*+0.85*
International Large Cap Value Fund	+10.90%	+ 9.68%	+31.03%	+0.80
International Small Cap Stocks				
-MSCI Small Cap EAFE Index (in US $, px only)	*+11.50%*	*+15.15%*	*+16.71%*	*+0.58*
International Small Cap Value Fund	+10.37%	+16.36%	+34.83%	+0.49
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*+ 17.01%*	*+21.98%*	*+35.45%*	*+0.73*
Emerging Markets Value Fund	+17.72%	+22.28%	+48.57%	+0.69

* 3 yr correlation using monthly data

Fixed Income Asset Class Category	**3Q2005**	**YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	*+ 0.09%*	*+ 1.03%*	*+ 1.68 %*	*-0.24*
Short Duration Domestic Inv. Gr. Bond Fund	+ 0.10%	+ 0.98%	+ 2.80%	-0.14
Short Duration Domestic Muni Bond Fund	+ 0.17%	+ 0.63%	+ 1.60%	-0.24
-Lehman Aggregate Bond Index	*- 0.67%*	*+ 1.82%*	*+ 3.96%*	*-0.19*
Domestic Investment Grade Bond Fund	- 0.49%	+ 2.39%	+ 5.20%	-0.15
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	*+ 0.91%*	*+ 1.67%*	*+15.54%*	*+0.34*
High Yield Bond Fund	+ 0.35%	- 1.10%	+10.56%	+0.64
Inflation-Linked Bonds				
-Lehman TIPS Index	*+ 0.02%*	*+ 2.74%*	*+ 6.68%*	*-0.23*
TIPS Fund	+ 0.18%	+ 2.80%	+ 7.12%	-0.23
Commodities-Linked Fund	+16.38%	+25.65%	+26.02%	-0.17
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*- 1.13%*	*- 6.77%*	*+ 9.53%*	*+0.01*
Non-$ Bond Fund	- 1.28%	- 7.69%	+ 9.86%	+0.01
Emerging Markets Debt				
-JP Morgan EMBI+ Index	*+ 3.40%*	*+ 8.70%*	*+21.44%*	*+0.35*
Emerging Markets Debt Fund	+ 3.96%	+ 9.62%	+24.05%	+0.32

* 3 yr correlation using monthly data