The Lam Group
Investment Management

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The Big Picture: The Certainty of Instability, Part II

In last quarter's newsletter, the question was asked:

If a historically risky asset class has not exhibited volatile behavior or poor performance for a period of time, could one reasonably conclude that this particular market is no longer risky?

The second quarter of 2006 has given us a clear answer to this question. Equity asset classes such as domestic and international small cap and emerging markets suffered greatly in late May and June (for the first time in over three years), while strong performance of commodities and non-$ bonds helped offset the negative effects of this near-term equity market volatility in balanced investment portfolios.

As a consequence, the aggregate 2Q 2006 results for properly-diversified balanced portfolios do not reflect the high degree of volatility that individual equity asset classes experienced during this quarter.

Asset Class Category	2Q 2006	2006 YTD	12 month	5 Yr Annualized
Equity				
S&P 500 Index (Domestic Large Cap)	**- 1.44%**	+ 2.71%	+ 8.63%	+ 2.49%
Russell 2000 Index (Domestic Small Cap)	***- 5.03%***	*+ 8.21%*	*+14.58%*	*+ 8.50%*
Wilshire REIT Index (REITs)	**- 1.20%**	+14.40%	+22.06%	+20.17%
MSCI EAFE Index (International Large Cap)	**+ 0.70%**	+10.16%	+26.56%	+10.02%
MSCI EAFE Small Cap Index (Int'l Small Cap)	***- 3.81%***	*+ 6.38%*	*+28.39%*	*+18.69%*
MSCI EMF Index (Emerging Markets)	***- 5.11%***	*+ 5.81%*	*+32.27%*	*+18.35%*
Fixed Income				
Lehman Aggregate Bond Index (Dom. Invest. Grade)	**- 0.80%**	- 0.72%	- 0.81%	+ 4.97%
CSFB High Yield Bond Index (Non-Invest. Grade)	**+ 0.39%**	+ 3.49%	+ 5.03%	+ 9.66%
Citigroup Non-$ Bond Index (International Bonds)	***+ 4.04%***	*+ 3.84%*	*- 0.02%*	*+ 9.60%*
JP Morgan Emerging Markets Debt Index (EM Debt)	**- 2.15%**	- 0.70%	+ 4.61%	+11.18%
Lehman TIPS Index (TIPS)	**+ 0.49%**	- 1.77%	- 1.64%	+ 7.00%
DJ AIG Commodities Index (Commodities)	***+ 6.13%***	*+ 3.58%*	*+18.10%*	*+13.73%*

It is worth noting that the equity asset classes that had some of the worst results in 2Q2006 are the asset classes that have had some of the best longer-term performance. This irony is illustrative of the long-term risk/return relationship at the most basic level:

experiencing high returns is unlikely without taking some level of risk

The second quarter of 2006, particularly the period after May 10th, was a loud reminder that risk is an integral part of the global investment landscape, and that markets and portfolio values can go down, sometimes meaningfully and often more quickly than expected.

With the incredible performance of the domestic and international small cap equity and emerging market equity asset classes over the last three years (over this period, each of these asset classes was up between 19% and 33% annually), it was unlikely that these markets would be able to continue to perform without a correction of some magnitude. Obviously, as these are the some of riskiest asset classes, the recent volatility should not have been unexpected, yet was also impossible to predict from a market-timing perspective.

Higher returns are inextricably linked with higher risk. Over the long run, individual asset class risk can be mitigated by using proper diversification techniques such as adding asset classes with low relative correlation (real estate, commodities, non-$ bonds, etc.) to offset individual risks at the aggregate portfolio level.

In the short run, however, the portfolio benefits of diversification do not always manifest themselves immediately and brief spikes in volatility can negatively affect both asset class and aggregate portfolio values. As the market volatility in the last half of 2Q 2006 has shown us, a focus on the long-term is not always easy, but nevertheless necessary. More importantly, volatile markets create rebalancing opportunities when asset classes with good long-term risk/return characteristics become more attractively priced.

A Context for Risk and Return: The Asset Allocation Plan - Revisited

It is important to take risk intelligently without allowing emotions or fears affect the investment decision-making process. To do this, an investor must appreciate that markets are unpredictable, and accept that the unexpected is possible. In times of high volatility, it is important not to panic.

It has always been our view that, over the long run, market-timing does not work; and the only way to consistently *"buy low and sell high"* without trying to time the markets is to have a well-defined, multi-asset class portfolio allocation plan and to periodically rebalance the underlying asset classes when market forces "unbalance" the portfolio relative to the original plan.

The original asset allocation plan should provide the overall template of asset classes and should represent the aggregate portfolio risk an investor is willing to accept. The rebalancing discipline is essential to manage the overall risks an investor is exposed to in a multi-asset class portfolio. As asset class values rise or fall, they are periodically sold or bought (respectively), to maintain the overall portfolio balance and risk profile.

This discipline is especially important during times of high uncertainty and market volatility, as it prevents the investor from making emotional decisions which can lead to short-term performance chasing, and can be damaging to long-term portfolio performance regardless of market direction.

Over the long run, chasing short-term performance can be regarded as a *"buy high and sell low"* strategy. Buying internet stocks in early 2000 or selling stocks (of any kind) immediately after the tragedy of 9/11 are good examples of this backwards strategy.

From an investment standpoint, the best asset class purchases are made during the most turbulent of times, and the best asset class sales are best made when "skies are clear". By having the context of a thoughtful portfolio asset allocation plan, the ability to recognize which asset classes have done well (and more importantly, have not done well), becomes more clear, and as a consequence, the ability to act on this information, without emotion, allows for better management of overall portfolio risk.

With the recent market volatility, an undisciplined investor without the context of an asset allocation plan, might be inclined to sell all equities exposures and "load up" the portfolio with high-flying commodities and non-$ bonds; these would be emotional and unwise long-term investment decisions.

As the direction of markets and investment asset classes in general are increasingly impossible to predict, the importance of having a globally-diversified asset allocation plan, a risk-based rebalancing discipline, and a long-term investment horizon cannot be overemphasized.

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It is important to remember that as investors, we cannot have an expectation of positive return without assuming some level of risk, the risks taken must be intelligent and purposeful.

At The Lam Group, the balanced portfolio approach we take utilizes a highly analytical process to determine the appropriate combination of 12 distinct asset classes, each of which offering a unique element of diversification to an aggregate investment portfolio and allows us to build investment strategies that realistically and optimally reflect the needs, risk tolerances, and investment horizons of our clients.

While 2Q 2006 was a difficult quarter for the equity markets worldwide, our globally-diversified and balanced portfolios mitigated much of this volatility and as a consequence the performance of our strategy continues to be strong on YTD and longer-term basis from both relative and absolute perspectives.

We are pleased to have made several appearances in the media over the last few months:

- Wall Street Journal – Getting Going, May 3, 2006
- Barron's – Market Watch, May 1, 2006
- BrainstormNW – Investment Advisors: 2006 Top Picks, March 2006

The Lam Group
Investment Management

The Lam Group is an independent, fee-only, SEC-registered investment advisory firm with over $185 million in assets under management with 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.

We are now accepting new clients on a referral-basis only, with a $2 million initial minimum.

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July 24, 2006

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	**2Q 2006**	**2006 YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*- 1.91%*	*+ 3.51%*	*+13.06%*	*+0.99*
US Total Market Fund	- 1.94%	+ 3.34%	+12.86%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	*- 1.44%*	*+ 2.71%*	*+11.22%*	*+1.00*
Domestic Large Cap Value Fund	+ 1.79%	+ 8.10%	+19.45%	+0.93
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*- 5.55%*	*+ 6.66%*	*+20.01%*	*+0.85*
-Russell 2000 Index	*- 5.03%*	*+ 8.21%*	*+18.70%*	*+0.83*
Domestic Small Cap Value Fund	- 3.40%	+11.15%	+26.50%	+0.78
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*- 1.20%*	*+14.40%*	*+27.69%*	*+0.37*
REIT Fund	- 1.50%	+13.68%	+26.57%	+0.35
Real Estate Fund	- 1.48%	+ 8.82%	+23.93%	+0.56
International Real Estate	- 5.52%	+ 9.18%	+31.05%	+0.67
International Large Cap Stocks				
-MSCI EAFE Index	*+ 0.70%*	*+10.16%*	*+23.94%*	*+0.86*
International Large Cap Value Fund	+ 0.10%	+12.47%	+30.05%	+0.84
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*- 3.81%*	*+ 6.38%*	*+32.61%*	*+0.67*
International Small Cap Value Fund	- 2.70%	+ 9.65%	+33.60%	+0.58
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*- 5.11%*	*+ 5.81%*	*+30.98%*	*+0.79*
Emerging Markets Value Fund	- 3.95%	+ 9.20%	+41.16%	+0.75

* 5 yr correlation using monthly data

Fixed Income Asset Class Category	**2Q 2006**	**2006 YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	*+ 0.66 %*	*+ 1.08%*	*+ 1.48 %*	*-0.54*
Short Duration Domestic Inv. Gr. Bond Fund	+ 0.39%	+ 0.55%	+ 1.56%	-0.34
Short Duration Domestic Muni Bond Fund	+ 0.54%	+ 0.90%	+ 1.27%	N/A
-Lehman Aggregate Bond Index	*- 0.08%*	*- 0.72%*	*+ 2.05%*	*-0.35*
Domestic Investment Grade Bond Fund	- 0.29%	- 0.81%	+ 2.57%	-0.28
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	*+ 0.39%*	*+ 3.49%*	*+ 8.92%*	*+0.57*
High Yield Bond Fund	+ 2.11%	+ 6.27%	+10.37%	+0.62
Inflation-Linked Bonds				
-Lehman TIPS Index	*+ 0.49%*	*- 1.77%*	*+ 3.76%*	*-0.30*
- Dow Jones AIG Commodities Index	*+ 6.13 %*	*+ 3.58 %*	*+17.22%*	*+0.09*
TIPS Fund	+ 0.58%	- 1.49%	+ 4.14%	-0.30
Commodities-Linked Fund	+ 5.31%	- 0.57%	+18.07%	N/A
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*+ 4.04%*	*+ 3.84%*	*+ 5.05%*	*-0.17*
Non-$ Bond Fund	+ 3.93%	+ 3.41%	+ 4.39%	-0.11
Emerging Markets Debt				
-JP Morgan EMBI+ Index	*- 2.14%*	*- 0.69%*	*+ 9.80%*	*+0.40*
Emerging Markets Debt Fund	- 1.94%	- 0.75%	+10.58%	+0.49

* 5 yr correlation using monthly data