The Lam Group
Investment Management

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The Big Picture: Low Expectations and Global Liquidity

We started 2006 with low expectations: US interest rates were poised to move higher, the domestic housing market was beginning to cool, and worldwide the stock and bond markets had just completed an unprecedented three year rally. While some expected the markets in 2006 to have some level of correction, very few (including us) expected the global markets to do as well as they did. 2006 was a surprising year, due in large part to the continued growth in global liquidity.

We begin 2007 with the same modest return expectations but for different reasons. On one hand, an argument can be made for a very favorable investment climate. The world is awash in liquidity: US interest rates are expected to decline and the supply of publicly-traded companies in the domestic stock market is shrinking due to the alarming growth of private equity investments. Further, domestic equity markets historically have rallied in the year prior to a US Presidential election.

On the other hand, "trees (and markets) do not grow to the sky", and the global equity markets have now completed four straight years of positive returns and we begin the fifth year in record-breaking territory. If equity performance is to return to historical averages, at some point the equity markets have to go down (or at least appreciate at lower rates). It is unrealistic to think the markets can continue to rise indefinitely, and if the global liquidity the markets have enjoyed over the past several years were to diminish, it is likely future investment returns would also decline.

Once again, markets are impossible to predict, and the importance of portfolio balance and diversification cannot be over emphasized. However, the issue of increasing global liquidity looms large and cannot be ignored.

Simply put, liquidity is the ready and easy availability of cash for investment, whether this cash is created by borrowing at low interest rates (i.e. the Japanese carry trade), borrowing enormous sums using superior credit (i.e. the US Treasury borrowing which increases the federal budget deficit), or generated by profitable global businesses (China manufacturing cheap goods and nations that produce oil are paid in US dollars; as these US dollar balances abroad grow, the US trade deficit widens).

When too much cash chases a limited amount of assets, asset prices go up.

In this sense, the world markets have experienced asset price inflation due to the unprecedented availability of capital. Asset prices can go up (not enough supply) as the value of the currency goes down (too much supply). It is important not to confuse asset price inflation with long-term economic prosperity or stability as rising asset prices can simply mean that there is too much capital available.

Stated differently, despite the rise in price of our assets, has our purchasing global power increased or decreased? The question of relative purchasing power is an important one in the context of inflation, the value of the US currency, and ultimately the value of our assets to those elsewhere in the world.

How Much Purchasing Power Have We Lost?

Domestic Asset Classes	**2006**	**3yr***	**5yr***	**10yr***
S&P 500 Index (Domestic Large Cap Stocks)	+15.79%	+10.44%	+ 6.19%	+ 8.42%
Nasdaq Composite Index (US Large Cap Growth Stocks)	+ 9.52%	+ 6.43%	+ 4.37%	+ 6.46%
Russell 2000 Index (US Small Cap Stocks)	+18.37%	+13.56%	+11.39%	+ 9.44%
Lehman Aggregate Bond (US Investment Grade Bonds)	+ 4.33%	+ 3.70%	+ 5.06%	+ 6.24%
International Asset Classes				
MSCI EAFE Index (Int'l Large Cap Stocks)	+26.34%	+19.93%	+14.98%	+ 7.71%
MSCI EAFE Small Cap Index (Int'l Small Cap Stocks)	+19.31%	+25.34%	+23.98%	N/A
MSCI EMF Index (Emerging Markets Stocks)	+29.18%	+27.26%	+23.52%	+ 6.73%
Citigroup Non-$ Bond Index (Intl Bonds, unhedged)	+ 6.94%	+ 2.88%	+ 9.50%	+ 4.70%
JPM Emerging Markets Global Bond Index (EM Debt)	+ 9.86%	+10.78%	+14.09%	+10.67%
Real Asset Classes				
Wilshire REIT Index (US REITs)	+36.13%	+27.37%	+23.84%	+15.29%
DJ AIG Commodities Index (Commodities)	+ 2.70%	+10.58%	+16.10%	+ 6.98%

* annualized returns as of 12/31/06

While investors who focus only on the US stock and bond markets may be comfortable with their investment returns over the past five years, it is precisely over this period that the US-centric investor has lost the most of his purchasing power relative to investors with a broader and more global focus. International (non-US dollar) and real asset (such as real estate and commodities) investments are up significantly more than US stock and bond investments. As a consequence of this greater compounded return, investors with broader and more global portfolios have more purchasing power than those who have been invested primarily in the US.

A reason for this loss of investment return/purchasing power is the inflationary impact of excessive liquidity around the world.

Where does this liquidity/capital come from?

As our government continues to spend, the US Treasury Department finances its borrowing by selling more US Treasury debt, thereby increasing the Federal budget deficit. Additionally, as our country continues import more goods than we export, our trade imbalance with other countries grows. These deficits (budget and trade) contribute heavily to the downward pressure on the value of the US dollar. A declining currency erodes our country's purchasing power.

To date, a disproportionately large portion of our debt is owned by foreign investors. It is widely believed that US interest rates have been held disproportionately low as a consequence of the volume of foreign investment in our bond market. The "foreign buyer" of our debt has been good for the bond market in our country, however, an argument can be made that our Treasury Department's financing sources are becoming decidedly less diversified as our reliance on the "foreign buyer" has grown. At the same time, an argument can be made that the foreign buyer may have too much of their investment portfolio in a single asset class: US Treasury Bonds.

What if the US dollar-rich "foreign-buyer" decides to diversify its investments?

As the value of the US dollar weakens, US assets become less expensive for foreigners to buy. In recent years, US dollar-rich nations have bought, or attempted to buy US assets on a larger scale. Some examples:

In 2006:
- Russian steel company Evraz purchased Oregon Steel Mills for $2.3 billion
- Dubai Ports World, a state-owned entity of the United Arab Emirates (UAE), attempted the purchase of the operating rights of six US ports.

In 2005:
- Chinese government-owned Lenovo purchased IBM's PC division for $1.75 billion
- Chinese company, CNOOC attempted an $18.5 billion purchase of US oil company Unocal.

The CNOCC and Dubai Ports World deals were most interesting as our government stopped the transactions since they were considered "not in our national interest", effectively sending the message to US dollar-rich countries like China and the UAE, that we really would prefer they use their US dollars to buy US Treasuries. While these transactions were stopped for reasons of national security, preventing this level of international free trade has the odor of protectionism.

Holders of large amounts of US dollars tend not to be stupid. It is likely that the explosive growth in private equity investment is not coincidental. With the world awash in US dollars and the growing perception that the only suitable foreign investment of US dollars is US Treasury bonds, a foreign investor has to ask:

Why not invest privately?

Purchases of publicly-traded US companies by private equity investment firms have increased dramatically over the last year. Given how much new capital these private equity firms have at their disposal to invest, it is likely that more large public companies will go private in the near future. With the compensation arrangements investors typically have with private equity firms, these firms have strong incentives (which may be in conflict with its investors) to make big investments regardless of how high a particular market or company's value might be.

As evidence of the impact of the massive global liquidity available to the private equity investor, the recently announced bidding war for Sam Zell's Equity Office Properties Trust (ticker: EOP, the country's largest REIT) is a good example. Despite the record-breaking and unprecedented performance of the US Real Estate Investment Trust (REIT) market over the last 7 years (Wilshire REIT Index up 329.3% for the period 2000-2006; up 23.1% on an annualized basis), at least two private equity-financed investors are competing against one another to purchase EOP for over $20 billion US dollars. One has to wonder what the loser(s) in this competition will do with their $20 billion war chest …

It is worth noting that private equity investment firms rarely disclose who their investors are.

If China, the oil producing nations, and/or other countries with surplus US dollars look beyond the US bond markets to invest these dollars, their appetite for, and the valuations of, companies, commodities, real estate and services may increase in the future. While rising asset prices have attractive prospects, if these foreign buyers make these acquisitions in lieu of their traditional US Treasury purchases, who will buy our bonds and keep US interest rates low?

Real assets, such as commercial real estate (including REITs) and other inflation-linked investments (TIPS and commodities) can provide meaningful diversification and risk/return characteristics to an investment portfolio, particularly in inflationary or weakening US dollar environments. The importance of having exposures to real assets will increase in preserving the long-term purchasing power of a global investment portfolio.

2007 Investment Outlook

Our investment outlook for 2007 is tempered with the perspective that it is rare that markets go up every year, and even more rare that they go up five years in a row. At the same time, the amount of liquidity available in the markets globally is staggering and with all that money chasing a limited amount of investment assets, asset prices can go up, again.

We continue to believe that markets are unpredictable and especially during times of high uncertainty (even in the presence of irrational optimism) the importance of balance, diversification and the acknowledgement of risk when managing investment portfolios cannot be overstated.

Given our outlook, it is important to make the distinction that a “favorable investment climate” and “vibrant and growing global economy” are not the same thing. In the presence of massive global liquidity, the corrosive effects of inflation must be seriously considered. Nevertheless, there will be opportunities to grow our investments in the coming year.

Here are The Lam Group’s 2007 predictions, strategies, ideas and biases:

General:

- Asset prices/market direction will be a function of global liquidity.
- In the presence of continued worldwide liquidity, the prices of assets are likely to go up, but inflationary pressures will also grow appreciably.
- If the availability of capital decreases, it is likely that asset prices and market returns will decline meaningfully.
- No investment decisions should be based solely on the direction of US interest rates as it is unclear which direction rates will go in 2007. On one hand, the Federal Reserve may need to lower rates due to a weakening domestic economy; on the other hand, foreign investors/central banks may demand higher bond yields if the US dollar continues its weakening trend.

Bonds:

- Domestic Fixed Income: Look to this asset class not for absolute return, but as a portfolio diversifier and risk dampener. With the Federal Funds Rate at 5.25%, it makes little sense to own longer-duration bonds without a clear sense of the direction of rates. Keep credit quality high for investment grade holdings and keep non-investment grade exposure to a minimum.
- International Fixed Income: The importance of this asset class from a risk management (low correlation) and diversification standpoint (currency) cannot be over-emphasized. Maintain full emerging markets debt allocation but rebalance majority of exposure to shorter duration holdings with non-$ instruments.
- Inflation-linked Fixed Income: Despite the poor performance of commodities in 2006, rebalance commodities exposures back to plan targets to manage portfolio risk and be prepared for continued volatility. Maintain adequate Treasury Inflation Protected Securities (TIPS) exposure.

Stocks:

- The liquidity provided to the markets by the enormous amount of private equity capital available should provide a meaningful support to global stock markets.
- As it is our belief the US dollar will continue weakening against developed market currencies, US companies will become increasingly attractive for foreign buyers to acquire who have surplus balances of US currency.
- With a weaker US dollar it is also likely that international stocks will continue to outperform domestic stocks, particularly in the small cap asset class where international small cap stocks have greater correlation to their local economies and currencies.
- Despite its incredible performance over the last 5 years, the emerging markets equity asset class should continue to perform favorably relative to equity markets in developed countries.
- The valuation of REIT and commercial real estate investments in general (real assets) have become less sensitive to the overall level of interest rates and more sensitive to the weakness of the US dollar and inflationary pressure. Since commercial real estate can't be "printed" as quickly or readily as the US Treasury can "print" more debt, real assets may hold their value better than financial assets.
- With the spectacular performance of the domestic REIT market over the past 7 years, portfolio risk management requires some degree of rebalancing (sell domestic/buy international real estate).

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 taken by The Lam Group takes 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
As The Lam Group completes our fifth year as an investment management firm, we are grateful to our clients and friends who have supported and helped us grow the firm a level where our globally balanced investment approach, and belief in passive-asset class management is gaining recognition as a unique, tax-sensitive, and low-cost way to manage portfolios for taxable families.

While it continues to be the policy of our firm to keep a low profile, we are fortunate to have made several appearances in the media over the last few months:

- Business Week – Personal Finance, October 23, 2006
- Portland Business Journal – Top 25 Financial Advisors, November 2006
- Portland Business Journal – Top 25 Money Managers, December 2006

Despite our recent additions to personnel and infrastructure, as a consequence of our growth in both number of clients (now 35) and assets under management (over $230 million), we are limiting the number of new clients we will work with in 2007. This limitation is to preserve the quality of our work and the direct access our current clients enjoy with us. The Lam Group will continue its policy of considering new clients on a referral-basis only, now with a $5 million initial minimum.

Nelson J. Lam
The Lam Group, Inc.
P.O. Box 850
Lake Oswego, OR 97034
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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	**4Q2006**	**2006**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*+ 7.32%*	*+15.97%*	*+11.54%*	*+0.99*
US Total Market Fund	+ 7.09%	+15.66%	+11.37%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	*+ 6.70%*	*+15.79%*	*+10.44%*	*+1.00*
Domestic Large Cap Value Fund	+ 8.05%	+20.18%	+16.14%	+0.92
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*+ 9.59%*	*+16.87%*	*+13.90%*	*+0.84*
-Russell 2000 Index	*+ 8.90%*	*+18.37%*	*+13.56%*	*+0.82*
Domestic Small Cap Value Fund	+10.14%	+21.55%	+18.00%	+0.76
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*+ 8.97%*	*+36.13%*	*+27.37%*	*+0.38*
REIT Fund	+ 8.95%	+35.27%	+26.44%	+0.38
Real Estate Fund	+ 9.85%	+30.17%	+24.03%	+0.49
International Large Cap Stocks				
-MSCI EAFE Index	*+10.35%*	*+26.34%*	*+19.93%*	*+0.85*
International Large Cap Value Fund	+12.03%	+34.15%	+25.82%	+0.81
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*+11.71%*	*+19.31%*	*+25.34%*	*+0.66*
International Small Cap Value Fund	+13.53%	+28.39%	+28.72%	+0.58
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*+17.28%*	*+29.18%*	*+27.26%*	*+0.77*
Emerging Markets Value Fund	+18.78%	+37.93%	+36.04%	+0.72

* 5 yr correlation using monthly data

Fixed Income Asset Class Category	**4Q2006**	**2006**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	*+ 0.98%*	*+ 4.12 %*	*+ 2.30%*	*-0.44*
Short Duration Domestic Inv. Gr. Bond Fund	+ 0.82%	+ 3.75%	+ 2.56 %	-0.23
Short Duration Domestic Muni Bond Fund	+ 0.69%	+ 2.84%	+ 1.74%	-0.02
-Lehman Aggregate Bond Index	*+ 1.24%*	*+ 1.33%*	*+ 3.70%*	*-0.28*
Domestic Investment Grade Bond Fund	+ 0.93%	+ 3.99%	+ 4.01%	-0.20
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	*+ 4.45%*	*+11.93%*	*+ 8.62%*	*+0.53*
High Yield Bond Fund	+ 4.12%	+12.10%	+ 9.44%	+0.59
Inflation-Linked Bonds				
-Lehman TIPS Index	*- 1.37%*	*+ 0.41%*	*+ 3.85%*	*-0.30*
TIPS Fund	- 1.53%	+ 0.28%	+ 3.97%	-0.29
-DJ AIG Commodities Index	*+ 5.40%*	*+ 2.07%*	*+10.58%*	*+0.01*
Commodities-Linked Fund	+ 2.45%	- 3.04%	+10.78%	N/A
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*+ 2.09%*	*+ 6.94%*	*+ 2.88%*	*-0.11*
Non-$ Bond Fund	+ 2.02%	+ 5.91%	+ 2.08%	-0.07
Emerging Markets Debt				
-JP Morgan EM Global Bond Index	*+ 3.83%*	*+ 9.86%*	*+10.78%*	*+0.46*
Emerging Markets Debt Fund	+ 4.05%	+ 9.78%	+11.25%	+0.48

* 5 yr correlation using monthly data

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