The Lam Group
Investment Management

**The Lam Group Newsletter Vol. 7, No. 4**
**Winter 2007**



## The Big Picture: Remember 1998

2007 was a challenging year and 2008 begins with a strong reminder that markets can go down.

*Portfolio balance and asset class diversification have never been of greater importance.*

In many ways the market volatility brought on by the subprime crisis is reminiscent of the problems that resulted from the Russian debt default in 1998. Some may remember Russia's default on their sovereign debt in August 1998 caused significant problems to the world financial system. The default of a seemingly unrelated capital market stressed the world's banking system to its limits and required emergency Federal Reserve action and ultimately resulted in the failure of the Long-Term Capital Management hedge fund (the largest failure of its kind at the time).

In 1998, the default of the Russian bond market forced hedge funds that were too highly-leveraged to sell investments of all types to meet capital requirements. Commercial banks that had lent money to hedge funds found that the level of leverage they extended exceeded many hedge funds ability to repay these loans in a timely fashion. A credit crisis for the banks ensued and the Federal Reserve had to act in a highly-publicized rescue to bail out an all-star list of banks that included lowering the Fed Fund and Discount Rates, as well as other liquidity providing actions.

*While almost 10 years has passed, the names have changed but the game has not*

In 2007, the subprime mortgage loan crisis caused over leveraged entities (hedge funds, SIVs, etc.) to again put our banking system in difficulty. As a consequence, our Federal Reserve has had to act aggressively by flooding the markets with liquidity (i.e. lowering rates and reserve requirements) to keep the markets afloat. While the current credit crisis is still unfolding, history has shown that decisive Fed action has always defeated credit and economic instability in our financial system.

Recent actions by our Federal Reserve to prevent further damage to the capital markets from subprime mortgages have essentially sent "helicopters" to air drop cash all over the investment landscape in an effort to reflate asset prices in this Presidential election year.

It is worth noting that during the darkest periods of the 1998 credit crisis, discussions of prolonged recession and fears of a global financial meltdown were as rampant as predictive warnings that "this time is different". Market historians will note, however, that 1998 was followed by 1999, which many would agree was a year of inflating asset prices for almost all asset classes.

While it is impossible to predict how long the current credit crisis will last, history has shown that all asset classes, including Russian/emerging market bonds, have rebounded nicely since 1998.

In periods of high market volatility, it is essential that investors with a long-term investment horizon not join the panic created by others (who often appear on financial news media outlets) who do not have an adequate capital markets framework to make decisions during turbulent times.

The unpredictability of markets and increased volatility in the financial system argue more strongly than ever for a diversified and globally-balanced investment approach. It is our belief that the market instability caused by the credit crunch over the last several months is severe, but will ultimately offer opportunities. We remain firmly committed to our long-term globally-balanced strategy.

**2008 Investment Outlook**
While 2008 is off to a difficult start for stocks, markets are unpredictable. We continue to believe that the importance of portfolio balance, global diversification and the acknowledgement of risk in the context of a long-term investment horizon are critical to the proper management of investment portfolios during highly volatile times.

Here are The Lam Group's 2008 predictions, strategies, ideas and biases:

General:
- Asset prices/market direction will continue to be a function of global liquidity.
- In the presence of accommodative monetary and fiscal policy, inflationary pressures will grow appreciably.
- It is likely that the US dollar weakens against other developed and emerging market currencies, particularly in the 2nd half of 2008.

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 3.00%, it makes little sense to own longer-duration bonds. Keep credit quality high for investment grade holdings and keep non-investment grade exposure to a minimum (for now).
- International Fixed Income: The importance of this asset class from a risk management (low correlation to equities) and diversification standpoint (unhedged currency exposure) 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: With strong commodities performance in 2007, rebalance commodities exposures back to original plan targets to manage portfolio risk and be prepared for continued volatility. Maintain full Treasury Inflation Protected Securities (TIPS) exposure.

Stocks:
- As it is our belief the US dollar will continue weakening against developed market currencies, US companies will become increasingly attractive acquisition targets for foreign buyers who have surplus balances of US currency (e.g. Sovereign Wealth Funds).
- With lower US stock prices, it is possible that US corporations with large cash balances (e.g. Microsoft) will look to make strategic domestic acquisitions and/or repurchase their stock.
- Despite its incredible performance over the last 5 years, the emerging markets equity asset class should continue to perform favorably relative to the equity markets in developed countries.

Real Assets
- If inflationary pressures continue to increase, real assets continue to be an important diversification element to a balanced portfolio.
- With longer-term US interest rates below 4%, REIT yields (globally) begin to look attractive.

**The Lam Group: Value vs. Growth**
The cornerstone of our equity strategy "tilts" our portfolio exposures towards small-cap and value-oriented stocks. History has shown that, while more volatile, small stocks generate higher returns than large stocks and value stocks generate higher returns than growth stocks over the long run.

However, in 2007 our small-cap/value equity orientation produced meaningfully lower returns than large-capitalization/growth-oriented equity strategies. While this relative underperformance is disappointing, investors must remember that our portfolios are positioned for longer time horizons.

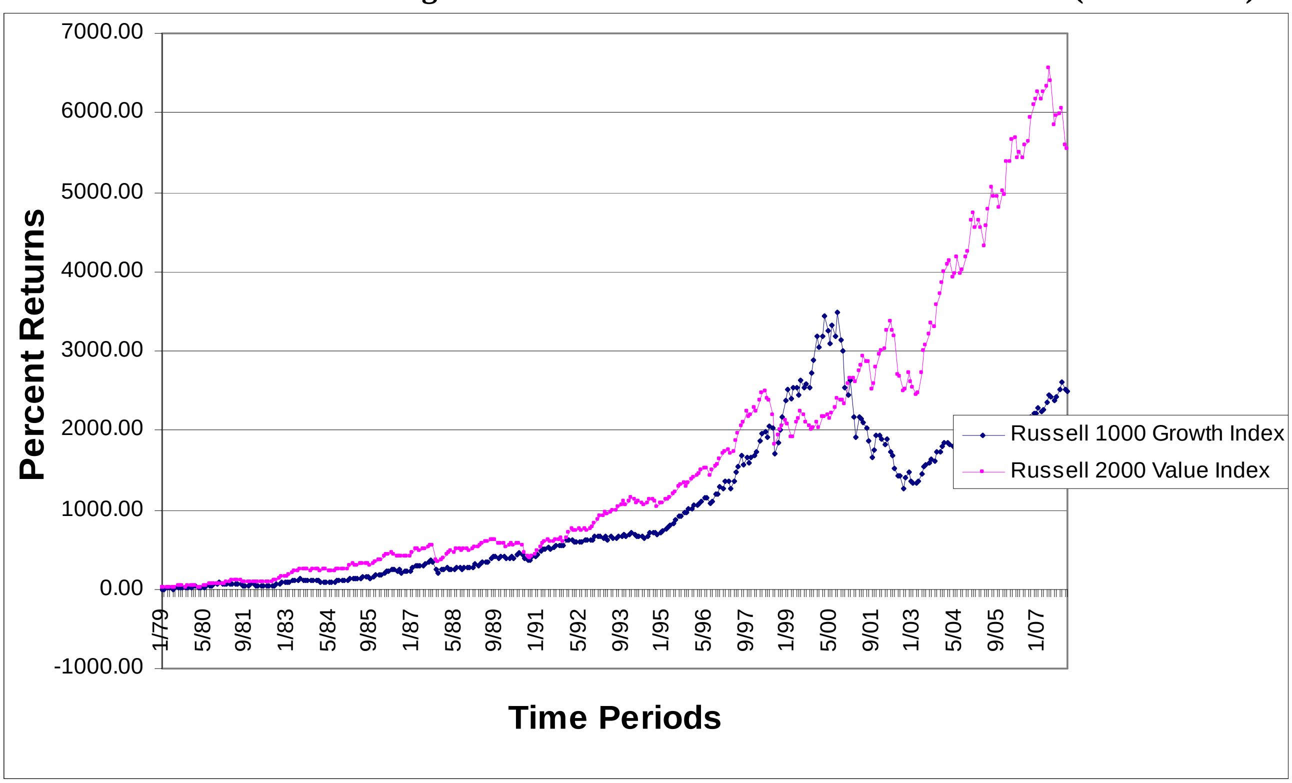
**Domestic Small/Value Advantage: Russell 2000 Value vs. Russell 1000 Growth**

| | | Annualized | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **2007** | **3 yr** | **5 yr** | **7 yr** | **10 yr** | **15 yr** | **20 yr** | **25 yr** | **Since 1/79** | **SD*** |
| R2000V | - 9.8% | + 5.3% | +15.8% | +11.2% | + 9.1% | +12.5% | +13.3% | +13.3% | +14.9% | 16.1 |
| R1000G | +11.8% | + 8.7% | +12.1% | + 0.2% | + 3.8% | + 8.5% | +10.7% | +11.2% | +11.9% | 17.3 |
| SmVal vs LgGrw | -21.6% | - 3.4% | + 3.7% | +11.0% | + 5.2% | + 4.0% | + 2.7% | + 2.1% | + 3.0% | |

*standard deviation for the period 1/79-12/07 using monthly data

The long-term rewards of a small/value orientation is meaningful as the long-term data includes the years where large/growth equity strategies "could do no wrong" (i.e. 2007/1999/1998).

**Domestic Small/Value Advantage: Russell 2000 Value vs. Russell 1000 Growth (1/79 – 12/07)**



As a consequence, we do not believe in chasing large cap/growth strategies during periods of relative short-term outperformance especially when the corrosive effects of additional transactions costs and the potential for unnecessary capital gains taxes are considered.

Despite our small/value portfolio “tilt”, our fully-invested and balanced strategy produced respectable results in the midst of a very difficult market environment in 2007 and is well-positioned for the future. In this sort of market environment, it is important to consider portfolio results in aggregate and in the context of a long-term time horizon.

The Lam Group continues to focus on designing and managing globally diversified investment portfolios and overseeing our client’s risks by only including investment asset classes which have low relative correlation in the context of an aggregate portfolio. Our asset allocation approach employs 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 an independent, fee-only, SEC-registered investment advisory firm with over $270 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.

In 2008, we will continue its policy of considering new clients on a referral-basis only with a $5 million initial portfolio minimum.

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February 12, 2008

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.

**All data is as of 12/31/07**

| **Equity Asset Class Category** | **4Q 2007** | **2007** | **3 Year Annualized** | **Correlation w/ S&P 500*** |
|---|---|---|---|---|
| *Domestic Total Equity Market* | | | | |
| *-Wilshire 5000 Index (Total Dom. Eq. Market)* | *-3.08%* | *+ 5.73%* | *+ 9.21%* | *+0.99* |
| US Total Market Fund | -3.32% | + 5.56% | + 9.01% | +0.99 |
| *Domestic Large Cap Stocks* | | | | |
| *-S&P 500 Index* | *- 3.33%* | *+ 5.49%* | *+ 8.62%* | *+1.00* |
| Domestic Large Cap Value Fund | - 5.39% | - 2.77% | + 8.81% | +0.93 |
| *Domestic Small Cap Stocks* | | | | |
| *-CRSP 6 -10 Index* | *N/A* | *N/A* | *N/A* | *N/A* |
| *-Russell 2000 Index* | *- 4.58%* | *- 1.57%* | *+ 6.80%* | *+0.86* |
| Domestic Small Cap Value Fund | - 8.81% | - 10.75% | + 5.36% | +0.84 |
| *Real Estate Investment Trusts (REITs)* | | | | |
| *-Wilshire REIT Index* | *-13.54%* | *-17.56%* | *+ 8.46%* | *+0.53* |
| REIT Fund | -14.50% | -18.67% | + 7.57% | +0.53 |
| Real Estate Fund | - 7.06% | - 8.35% | +10.92% | +0.73 |
| International Real Estate | - 8.73% | + 2.84% | +18.73% | +0.70 |
| *International Large Cap Stocks* | | | | |
| *-MSCI EAFE Index* | *- 1.75%* | *+11.17%* | *+16.83%* | *+0.82* |
| International Large Cap Value Fund | - 3.69% | +10.24% | +19.46% | +0.85 |
| *International Small Cap Stocks* | | | | |
| *-MSCI Small Cap EAFE Index* | *- 4.85%* | *+ 1.45%* | *+15.16%* | *+0.66* |
| International Small Cap Value Fund | - 7.49% | + 2.95% | +17.66% | +0.66 |
| *Emerging Markets Equity* | | | | |
| *-MSCI Emerging Markets Free Index* | *+ 3.38%* | *+36.48%* | *+31.95%* | *+0.67* |
| Emerging Markets Value Fund | + 2.71% | +45.64% | +37.99% | +0.71 |

* 5 yr correlation using monthly data

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**All data is as of 12/31/07**

| **Fixed Income Asset Class Category** | **4Q 2007** | **2007** | **3 Year Annualized** | **Correlation w/ S&P 500*** |
|---|---|---|---|---|
| *Domestic Investment Grade Bonds* | | | | |
| *-Lehman 1-3 year Govt Bond Index* | *+ 2.30%* | *+ 7.10%* | *+ 4.30%* | *-0.21* |
| Short Duration Domestic Inv. Gr. Bond Fund | + 1.38% | + 5.25% | + 3.86% | -0.09 |
| Short Duration Domestic Muni Bond Fund | + 0.93% | + 3.58% | + 2.47% | -0.03 |
| *-Lehman Aggregate Bond Index* | *+ 3.00%* | *+ 6.97%* | *+ 4.56%* | *-0.08* |
| Domestic Investment Grade Bond Fund | + 3.92% | + 9.07% | + 5.29% | -0.09 |
| *Domestic High Yield Bonds* | | | | |
| *-CSFB High Yield Bond Index* | *- 1.04%* | *+ 2.66%* | *+ 5.52%* | *+0.55* |
| High Yield Bond Fund | - 3.92% | + 0.17% | + 4.71% | +0.65 |
| *Inflation-Linked Bonds* | | | | |
| *-Lehman TIPS Index* | *+ 4.97%* | *+11.64%* | *+ 4.85%* | *-0.13* |
| *- Dow Jones AIG Commodities Index* | *+ 4.73%* | *+16.23%* | *+12.92%* | *+0.10* |
| TIPS Fund | + 5.24% | +11.59% | + 4.73% | -0.11 |
| Commodities-Linked Fund | + 9.34% | +23.80% | +13.09% | +0.04 |
| *International (non-US $) Bonds* | | | | |
| *-Citigroup Non-$ World Govt Index* | *+ 3.91%* | *+11.45%* | *+ 2.67%* | *+0.08* |
| Non-$ Bond Fund | + 3.19% | +10.01% | + 1.57% | +0.09 |
| *Emerging Markets Debt* | | | | |
| *-JP Morgan EMBI+ Index* | *+ 2.63%* | *+ 6.27%* | *+ 8.94%* | *+0.32* |
| Emerging Markets Debt Fund | + 1.41% | + 5.62% | + 9.02% | +0.33 |

* 5 yr correlation using monthly data

***Disclaimer:***
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