The Lam Group Newsletter Vol. 8, No. 3
Autumn 2008

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The Big Picture: The Autumn of Discontent

2008 has been a challenging year, punctuated by a very difficult autumn.

Global markets encompassing virtually all asset classes have declined significantly and suddenly since August 2008.

Why has this happened? Have we suffered another 9/11-style attack? Has global warming achieved its potential and made large portions of the planet uninhabitable? Are we on the brink of nuclear war? Thankfully the answer to all of these questions is, and hopefully will continue to be: NO.

This current market panic, like many before it, stems from fear among individuals, as well as financial institutions that they will not be repaid for even the most basic forms of investment. Put another way, confidence in the financial system has disappeared. While no one is disputing that these are frightening and uncertain times, a reality check may be in order.

Is it realistic to believe that *all* of the world's financial institutions will cease to exist, taking all of our money with them? Is it possible that we and all our neighbors (near and far) will stop buying food or clothes or gasoline? Will the growing populations of China and India, who just a few months ago were hailed as the drivers of the world's future economic growth, all decide to return to their farms to tend to their flocks and fields? Despite the absurdity of these questions, the global markets are behaving as if the answer to all of them is: YES[1].

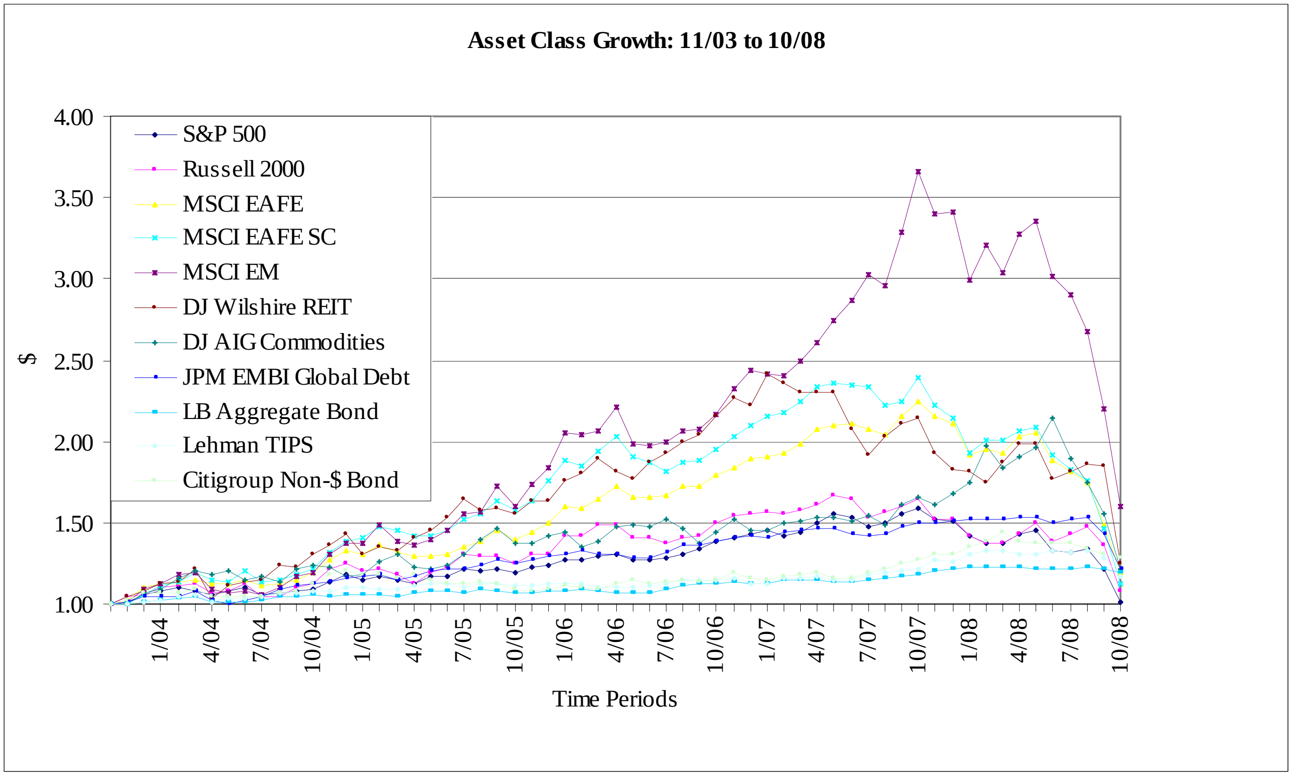
While the credit crisis has been upon us since August 2007, the wholesale meltdown of all asset classes (and the suspension of historical asset class correlation relationships) only began at the end of August 2008. The last 11 weeks have been brutal; however anything can happen for a short period of time.

In times of emotional and financial stress, it is important to have a long-term perspective and an appreciation of market history. While many in the media have compared the current crisis to the Great Depression of 1929, as of 10/31/08, it is worth noting that the S&P 500 is basically at the same level it was in November 2003. This 5-year period (November 2003 thru October 2008), includes the negative impacts of the recent September-October 2008 market performance.

As you can see from the graph on the next page, all asset classes (some more risky than the S&P 500, some less), have had positive returns over the same 5 year period. While this illustration is not meant to minimize the severity of the downturn, it puts it in a proper historical context.

It is fair to say that the current downturn has taken us back to 2003 levels, not 1929.

Cumulative Asset Class Returns from November 2003 to October 2008



Over the long-run, the expected return of a given investment should have a direct-correlation to the investment's cost-of-capital. Obviously the credit crisis has caused the cost-of-capital for all investments to rise significantly, and as a result the prices of investments are now adjusting to give long-term investors a fair expected return. *During this period of adjustment, it is difficult to predict which companies will survive and which companies will ultimately fail, however while individual securities/companies can go to zero, broadly-defined asset classes cannot.*

The suddenness of recent events may make it seem like everything is going down at the same time, and cast doubt on the merits of a diversified portfolio. However, one cannot, on the basis of a trailing 11 week interval, discard an investment philosophy proven with over 80 years of historical data that have included the market performance during the Great Depression, world wars, the oil shocks, internet bubbles, terrorist attacks, etc.

It is likely that the historical relationships between lowly-correlated asset classes will reassert themselves as the markets stabilize and the benefits of a having a well-diversified portfolio strategy will become more apparent.

While we are optimistic that the new administration will be able to implement the full powers intended by Emergency Economic Stabilization Act of 2008 and the Troubled Asset Relief Program (TARP) and eventually restore confidence and liquidity in the financial system, there will be adverse and long-lasting consequences from this crisis.

In the interim, it is likely that we will experience a global recession and that both GDP growth and corporate earnings will trend negative. History has shown that aggressive monetary and fiscal policies to have been effective in limiting the scope and duration of recessions. The recent concerted stimulative efforts of the world's central banks and governments are evidence of lessons learned from past financial crises.

How long the current recession will last is anyone's guess; however one of the adverse and long-lasting consequences of any stimulus-based recovery will be inflation.

Buy Low, Sell High:
Over the last 12 months, risky assets of all types plummeted and fear has caused a "flight-to-quality", pushing yields on 30-day US Treasury Bills to less than ½%. At one point, the yield on 30-day US Treasury Bills had gone to 0% reflecting the raw emotion at work in the market.

Asset class returns can be misleading when looking at short periods of time in isolation rather than considering longer periods.

1 Year Asset Class Returns as of 10/31/08

Asset Classes Ranked by 12 Month Returns	**12 Month Return**
Lehman Brothers 1-3yr Government Bond Index (Domestic Fixed Income)	+ 6.26%
Citicorp Non-$ World Bond Index (International Fixed Income)	+ 0.65%
Lehman Brothers Aggregate Bond Index (Domestic Fixed Income)	+ 0.30%
Lehman Brothers TIPS Index (Inflation-Linked Domestic Fixed Income)	- 4.11%
JPM Emerging Markets Global Debt Index (Emerging Markets Debt)	-19.11%
DJ AIG Commodities Index (Commodities)	-26.61%
Russell 2000 Index (Domestic Small Cap Equity)	-34.16%
S&P 500 Index (Domestic Large Cap Equity)	-36.10%
DJ Wilshire REIT Index (Domestic REITs)	-41.48%
MSCI EAFE Index (International Large Cap Equity)	-46.62%
MSCI EAFE Small Cap Index (International Small Cap Equity)	-54.65%
MSCI Emerging Markets Index (Emerging Markets Equity)	-57.35%

If we take the fresh perspective of someone who is just beginning their investment experience today, what would you buy? An intelligent approach would be to look at some long-term historical returns.

10 Year (Annualized) Asset Class Returns as of 10/31/08

Asset Classes Ranked by 10 Year Annualized Returns	**10 Year Return***
JPM Emerging Markets Global Debt Index (Emerging Markets Debt)	+ 9.60%/ ***+150.0%***
DJ Wilshire REIT Index (Domestic REITs)	+ 8.92%/ ***+135.0%***
DJ AIG Commodities Index (Commodities)	+ 7.70%/ ***+110.1%***
MSCI Emerging Markets Index (Emerging Markets Equity)	+ 7.34%/ ***+103.0%***
Lehman Brothers TIPS Index (Inflation-Linked Domestic Fixed Income)	+ 6.13%/ ***+ 81.3%***
Lehman Brothers Aggregate Bond Index (Domestic Fixed Income)	+ 5.00%/ ***+ 63.2%***
Russell 2000 Index (Domestic Small Cap Equity)	+ 4.90%/ ***+ 61.3%***
Lehman Brothers 1-3yr Government Bond Index (Domestic Fixed Income)	+ 4.60%/ ***+ 56.9%***
Citicorp Non-$ World Bond Index (International Fixed Income)	+ 4.51%/ ***+ 55.7%***
MSCI EAFE Small Cap Index (International Small Cap Equity)	+ 2.61%/ ***+ 29.4%***
MSCI EAFE Index (International Large Cap Equity)	+ 1.67%/ ***+ 18.0%***
S&P 500 Index (Domestic Large Cap Equity)	+ 0.40%/ ***+ 4.04%***

*****Annualized/***Cumulative*** Returns thru 10/31/08

As you can see, asset class returns can vary greatly when short periods of time (e.g. 12 months) are compared with longer periods of time (e.g. 10 years). When considered in isolation, it is as difficult to know when to get back into a given asset class as it is to know when it is time to get out. A focus on the compounding effects of long-time horizon investing is essential.

With cash (in the form of 30-day US Treasury Bills) now currently yielding less than ½%, what should an investor (new or old) do?

While cash might be emotionally-satisfying during this period of uncertainty, it is likely that the ongoing globally-concerted monetary and fiscal stimulus plans will lead to inflationary pressures over the long-term. With cash yields so low, inflation is likely to be an investor's biggest enemy.

To protect an investor's long-term purchasing power, history has shown that riskier asset classes have been an effective hedge against inflation. Obviously, over the last 11 weeks, riskier asset classes have gone on sale where some asset classes are down over 50% over the last 12 months.

While it is not clear how long this sale will go on, it is unlikely that the store (the global financial system) will go out of business.

As we have said before, in practice: "buying low and selling high" is never easy or obvious, and some of today's best long-term investments may, when contemplated in the short-term, seem like insanity. A disciplined rebalancing strategy is essential to capture potential future performance (buying low) while limiting portfolio risks (selling high).

[1] the NO/YES portion of the newsletter was inspired by an email note from Greg Friedman, CIO of Greycourt

The Lam Group:
Global Deleveraging of the Financial System
The swiftness of the decline since the end of August 2008 has been breathtaking. As markets are impossible to predict, it is unclear how long the current malaise will last.

We believe the reason for this most recent downturn in the markets is directly related to a global deleveraging of the financial institutions (hedge funds, commercial and investment banks, and others) requiring these entities to get smaller/shed assets quickly and at the same time.

The reason financial institutions need to shed assets are many: hedge funds must sell assets to meet client redemptions and margin calls, and commercial/investment banks need to sell assets due to an inability to roll over their financing in the money markets (in addition to repairing their impaired balance sheets to meet regulatory capital requirements) are the most basic examples.

Many of the investments/assets (such as sub-prime mortgages, structured products and derivative holdings) that got these financial institutions in trouble are illiquid. As a consequence, these kinds of assets are currently unsaleable at any price as all their traditional buyers have become distressed and motivated sellers.

When wholesale forced-selling is required, financial institutions cannot sell what they want to, or should sell; *they must sell what can be sold quickly*. This urgency has led to the most liquid assets classes (such as stocks, bonds, commodities futures, REITs) to be sold *en masse* over the last 11 weeks. This has resulted in negative short-term performance for even some of the best investments.

Reacting to market headlines or trying to predict what the markets are going to do tomorrow can be a very expensive and ultimately unsatisfying game. It is worth noting that the vast majority of actively-managed strategies have meaningfully underperformed their respective passive strategies/benchmarks during this period of higher volatility. As always, it continues to be very difficult to pick***, in advance,*** active managers of specific asset classes who will be able to profitably time the markets and pick superior securities compared to properly-benchmarked passive strategies. History has shown that the ability to pick superior active managers in advance <u>and</u> consistently is practically impossible.

Consequently, during these periods of uncertainty, the best/only thing to do is stay committed to the long-term allocation plan and keep investment expenses (using passive asset class strategies) and taxes (by employing a tax-loss harvesting/rebalancing discipline) to a minimum.

We continue believe in our diversification strategy for investors with a long-term investment horizon and feel that this downturn is creating many attractive investment opportunities for the future.

Tax-Loss Harvesting
Tax loss harvesting is especially important this year and will help minimize the potential negative effects of capital gains tax increases that have been widely discussed by the new administration.

The Lam Group is an independent, fee-only, SEC-registered investment advisory firm 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, and foundations.

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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.

All data is as of 10/31/08

Equity Asset Class Category	**3Mos.**	**2008 YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*-24.14%*	*-33.01%*	*-5.10%*	*+0.99*
US Total Market Fund	-24.00%	-32.36%	-4.81%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	*-23.11%*	*-32.84%*	*-5.21%*	*+1.00*
Domestic Large Cap Value Fund	-28.11%	-36.43%	-8.20%	+0.96
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*N/A*	*N/A*	*N/A*	*N/A*
-Russell 2000 Index	*-24.48%*	*- 29.02%*	*-4.79%*	*+0.89*
Domestic Small Cap Value Fund	-24.50%	-30.97%	-7.83%	+0.87
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*-31.14 %*	*-31.54%*	*-7.02%*	*+0.73*
REIT Fund	-29.98%	-30.38%	-7.15%	+0.73
International Real Estate	-38.17%	-50.40%	N/A	N/A
International Large Cap Stocks				
-MSCI EAFE Index	*-34.49%*	*-43.54%*	*-5.27%*	*+0.90*
International Large Cap Value Fund	-36.62%	-46.80%	-5.66%	+0.92
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*-39.25%*	*-48.10%*	*-11.20%*	*+0.82*
International Small Cap Value Fund	-35.18%	- 43.40%	-6.74%	+0.82
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*-45.24%*	*-54.20%*	*-2.60%*	*+0.81*
Emerging Markets Value Fund	-47.92%	-55.65%	+0.55%	+0.84

* 5 yr correlation using monthly data

All data is as of 10/31/08

Fixed Income Asset Class Category	**3Mos.**	**2008 YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	*+1.77%*	*+4.30%*	*+5.42%*	*-0.34*
Short Duration Domestic Inv. Gr. Bond Fund	+0.64%	+2.39%	+4.23%	-0.04
Short Duration Domestic Muni Bond Fund	+0.06%	+1.30%	+2.73%	+0.15
-Lehman Aggregate Bond Index	*- 2.76%*	*-1.74%*	*+3.60%*	*+0.13*
Domestic Investment Grade Bond Fund	- 3.08%	-1.04%	+4.41%	+0.17
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	*-21.55%*	*-23.49%*	*-3.72%*	*+0.86*
High Yield Bond Fund	-20.05%	- 22.62%	-4.52%	+0.85
Inflation-Linked Bonds				
-Lehman TIPS Index	*- 11.47%*	*-7.62%*	*+1.64%*	*+0.29*
- Dow Jones AIG Commodities Index	*-35.43%*	*-27.59%*	*-0.86%*	*+0.37*
TIPS Fund	- 11.99%	-7.55%	N/A	N/A
Commodities-Linked Fund	-45.34%	-37.55%	-7.98%	+0.38
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*-6.84%*	*-1.37%*	*+5.35%*	*+0.10*
Non-$ Bond Fund	-8.10%	-3.17%	+3.87%	+0.13
Emerging Markets Debt				
-JP Morgan EMBI+ Index	*-20.07%*	*-19.33%*	*-0.88%*	*+0.71*
Emerging Markets Debt Fund	-22.71%	-22.29%	-2.16%	+0.71

* 5 yr correlation using monthly data

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