The Lam Group
Investment Management

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- The Big Picture: The Fall of 2008
- The Lam Group: Madoff
- Asset Class Investment Results

The Big Picture: The Fall of 2008

2008 was a difficult year for virtually every asset class. As you can see from Table 1 the vast majority of the declines for 2008 occurred during the three-month period of September thru November 2008.

Table 1: Asset Class Returns for 2008 and the 3-month period of deleveraging (8/31/08-11/30/08)

EQUITY ASSET CLASSES	**2008**	**8/31/08-11/30/08**
S&P 500 Index - Domestic Large Cap Stocks	-37.00%	-29.65%
Russell 2000 Index - Domestic Small Cap Stocks	-33.80%	-35.73%
MSCI EAFE Index - International Large Cap Stocks	-43.39%	-35.42%
MSCI EAFE SC Index - International Small Cap Stocks	-46.78%	-39.58%
MSCI EM Index - Emerging Markets Stocks	-54.48%	-44.89%
DJ Wilshire REIT Index - Domestic Real Estate	-39.20%	-49.19%
FIXED INCOME ASSET CLASSES	**2008**	**8/31/08-11/30/08**
Barclays Aggregate Bond Index - US High-Grade Bonds	+ 5.24%	- 0.54%
CSFB High Yield Index	-26.17%	-28.52%
Lehman TIPS Index - US TIPS	- 2.35%	-11.56%
DJ AIG Commodities Index - Commodities	-35.65%	-35.22%
Citigroup Non-$ World Bond Index - Non-$ Bonds	+10.22%	- 0.94%
JPM EMBI Global Bond Index - Emerging Markets Debt	-10.91%	-18.75%

What happened during this period? Let’s review the highlights:

In September, large financial institutions experienced severe distress:
- Fannie Mae, Freddie Mac and AIG were taken under Federal conservatorship
- Bank of America bought an imploding Merrill Lynch
- Lehman Brothers declared bankruptcy
- Washington Mutual was seized by Federal regulators and sold to JP Morgan
- The Big Three US automakers made an initial request for bailout
- Sellers of Credit Default Swap (CDS) insurance suffered steep losses

In October, the institutional failures of September caused a crisis of confidence and liquidity in the capital markets:
- The US Treasury initiated a program to buy commercial paper directly to preserve corporate liquidity
- The G7 countries cut interest rates globally in a coordinated effort to boost liquidity in the financial system

- The US Treasury finalized the details of its plan to guarantee money market funds
- The US, joined by central banks around the world, led a massive global capital injection ultimately resulting in its $700 billion Troubled Asset Relief Program (TARP)

In November, with the uncertainty of the Presidential election behind us:
- The Big Three US automakers asked Congress for bailout funds, citing survival concerns
- Recessionary economic data and concerns about unemployment grew

Any one of the headlines in the autumn of 2008 could have caused turbulence in the financial system. To have all these events (and more) happen in such a concentrated period of time was unprecedented.

As a consequence of the volatility brought on by the events described above, leveraged financial institutions such as hedge funds, finance companies, and commercial and investment banks were forced to sell assets to maintain reserve requirements, meet margin calls and investor redemptions. While the cause of this *forced sale* of assets was related to the steep decline in value of complex derivatives holdings such as CDS and subprime/structured mortgage investments, these financial institutions needed to move quickly selling their more liquid and higher-quality holdings such as stocks, bonds, commodity futures, rather than the illiquid and leveraged investments that were at the heart of the problem.

This massive and sudden deleveraging of the financial system left virtually all asset classes (with the exception of sovereign debt) in significant decline. These declines had less to do with the value of the underlying investments and more to do with the speed at which the proceeds of the sales (cash) was needed.

In response to this global decline of the markets, and in anticipation of the decline in the real economy, governments and central banks around the world legislated highly-stimulative monetary and fiscal policies on an unprecedented scale. While it will take some time for the implementation of these policies to take effect, there is no doubt about the intent or seriousness and the efforts of all affected nations to restore confidence in the global financial system.

While there is no question that the current financial crisis is broader and deeper than any we have faced in our lifetimes, it is important to realize that all of the major financial crises that have been experienced in the past were broader and deeper than the ones preceding it. To paraphrase a comment author Michael Lewis recently made on Bloomberg, “it seems like the 100 year storm happens every 10 years...”

Ironically the beginning of the trailing 10-year period coincides with the end of the last major credit crisis. As a memory refresher, in late 1998, the Russian bond market (a segment of the emerging markets debt asset class) defaulted, resulting in a massive and sudden deleveraging that disrupted the capital markets and caused the failure of LTCM (Long-Term Capital Management, the largest hedge fund in the world at that time). At the height of this crisis, the Federal Reserve called an emergency weekend meeting to stabilize the financial system and provided unprecedented amounts of liquidity to the system to save and/or support member banks and non-member financial institutions.

As we can see from the data on Table 2 (with 2008 performance data included), virtually all asset classes have rebounded over the last 10 years. The most noteworthy is the 10-year performance of emerging market debt.

Table 2 – Asset Class Returns for the 10 Year Period 1999-2008, Annualized and Aggregate

EQUITY ASSET CLASSES	Annualized 10yr Return	*Standard Deviation**	Aggregate 10yr Return	*Correlation* w/S&P 500*
S&P 500 Index - Domestic Large Cap Stocks	- 1.38%	*15.10*	- 12.99%	*+1.000*
Russell 2000 Index - Domestic Small Cap Stocks	+ 3.02%	*20.36*	+ 34.72%	*+0.762*
MSCI EAFE Index - International Large Cap Stocks	+ 0.80%	*16.43*	+ 8.25%	*+0.849*
MSCI EAFE SC Index - International Small Cap Stocks	+ 4.71%	*18.28*	+ 58.52%	*+0.701*
MSCI EM Index - Emerging Markets Stocks	+ 6.64%	*24.19*	+ 90.23%	*+0.771*
DJ Wilshire REIT Index - Domestic Real Estate	+ 7.65%	*21.04*	+109.09%	*+0.468*
FIXED INCOME ASSET CLASSES	**Annualized 10yr Return**	***Standard Deviation****	**Aggregate 10yr Return**	***Correlation* w/S&P500***
Barclays Aggregate Bond Index - US High-Grade Bonds	+ 5.65%	*3.83*	+ 73.23%	*-0.088*
CSFB High Yield Index	+ 2.87%	*9.02*	+ 32.66%	*+0.632*
Lehman TIPS Index - US TIPS	+ 6.79%	*6.34*	+ 92.95%	*+0.008*
DJ AIG Commodities Index - Commodities	+ 7.61%	*17.42*	+108.26%	*+0.250*
Citigroup Non-$ World Bond Index - Non-$ Bonds	+ 5.62%	*8.52*	+ 72.74%	*-0.034*
JPM EMBI Global Bond Index – Emerging Markets Debt	+10.17%	*10.57*	+163.49%	*+0.531*

*10 year calculation using monthly data

During periods of high uncertainty, it is difficult to predict which securities will survive and which will ultimately fail, however while individual securities can go to zero, broadly-defined asset classes cannot. Despite the default of the Russian bond market in late 1998, the performance of emerging markets debt asset class for the past 10 years (+10.17% annualized, +163.49% aggregate) illustrates the benefits of not giving up on an asset class that has performed poorly and the importance of disciplined portfolio rebalancing.

Unfortunately, when considered during this concentrated period of financial system deleveraging, the diversification benefits of a multi-asset class portfolio (with underlying investments with low relative correlation) did not work. While sovereign bonds (domestic and foreign) offered some diversification benefits during this difficult time, other asset classes such as TIPS, REITs, commodities, and emerging markets debt did not play the diversifying role their historical correlations implied. However, given the 10-year performance of these asset classes, it is possible that the diversification benefits of these asset classes will represent themselves over a longer period of time.

Just because a long-term investment strategy did not work for a short period of time does not mean it is the wrong long-term strategy. Historically, credit crises of unprecedented magnitude (the LTCM failure in the late 90s and the S&L crisis in the late 80s among the most recent) are met by similarly unprecedented monetary and fiscal policies intended to reflate financial systems and restore investor confidence. Both of the crises of the recent past were followed by prosperous times for investors with patience and discipline. When things seem most uncertain, a solid understanding of the framework of the capital markets and an appreciation of history are necessary.

Over the long-run, the expected-return on investments and the cost-of-capital should be expected to converge. In 2008, the global credit crisis caused the cost-of-capital to increase significantly and the prices of assets have adjusted (downward) to give investors a higher expected-return for the future.

The confluence of events in late 2008 was unexpected, and like all market events unpredictable. With all that happened in 2008 and the declines that were suffered, we as investors have already paid the price for the risk in the markets. We now must be patient and look forward to the (expected) return as the new valuations in many asset classes are at attractive levels.

While 2009 is off to an uncertain start, we continue to believe that portfolio balance, global diversification and the acknowledgement of risk in the context of a long-term investment horizon are important and critical to the proper management of investment portfolios during highly volatile times.

In the context of our portfolio strategy, investment themes for 2009 include:

Bonds:

- The global credit markets must stabilize in order for the global equity markets to recover.
- With Treasury rates close to zero, fixed-income investors will be forced to consider higher-yielding alternatives in the corporate, mortgage and asset-backed bond market. Investment-grade corporate bonds should lead any meaningful recovery in the stock market.
- Treasury Inflation-Protected Securities (TIPS) are currently priced at a level that implies little inflation in the future (the inflation option is almost free).

Stocks:

- The S&P 500, MSCI EAFE and MSCI EM equity indices in are now at levels last seen in 2002, 2003 and 2004 respectively.
- Equity markets globally have adjusted lower to give long-term investors higher expected returns.
- While the markets are lower, the concept of risk/return hasn’t changed; equity markets recoveries have historically been led by small-cap and value-oriented strategies.
- It would be as wrong to use 2008 equity asset-class performance to project into 2009-11 as it was to use 1999 equity asset-class performance to project into 2000-02.

Real Assets:

- In the presence of emergency-level monetary and fiscal policy, inflationary pressures will likely reemerge.
- While the performance of the commodities and real estate asset classes have been disappointing for the past 6 months and 18 months respectively, the implementation of aggressive monetary and fiscal policies should stimulate and eventually reflate the global economy. Real assets will play an important role and provide meaningful contributions to aggregate portfolio returns.

The Lam Group:
The December 2008 disclosure of the stunning $50 billion fraud by the investment firm owned by Bernard Madoff understandably has investors around the world questioning the integrity and legitimacy of their investment managers.

The red flags in this case were many. Madoff required all the assets he managed to be custodied at his firm only (a custodian is the entity that holds the assets). Additionally, his firm acted as sole broker-dealer (the market-maker for securities trades) while also acting as investment manager. Having all three functions (custodian, broker-dealer and investment manager) performed by the same entity has inherent conflicts-of-interest and dramatically limits the necessary transparency and checks and balances an investor should demand to insure the integrity of their assets.

An additional red flag was that for over 20 years Madoff claimed only to produce positive returns, which is incredible given his equity-oriented strategy. Such false claims were easy to make since all the client account documents were generated by him.

Madoff leveraged his impressive (yet fraudulent) performance of his investment strategy with the perception of his firm's exclusivity allowing him to require all clients to have his firm handle all of the critical back office functions supporting his investment management operation.

Clients of The Lam Group have their assets custodied by Schwab Institutional and/or Fidelity Institutional. Our client's relationship with the custodian is direct and primary; The Lam Group has limited power-of-attorney to direct trades in client custodial accounts and is prohibited from moving assets out of client account without express written instructions from the client. Clients have direct access to their custodial accounts on-line, by telephone, or by visiting one of Schwab or Fidelity's local offices at anytime, independent of The Lam Group.

Having an independent and third-party custodian is crucial to the safekeeping of client assets and ensuring the integrity of an investment management relationship.

Our clients get monthly statements directly from their respective custodians that detail all trading activity and portfolio holdings. Separately, our clients get quarterly statements from The Lam Group that details the holdings and performance of the aggregate portfolio. Ultimately, the information from these statements should match and any discrepancies (unrelated to settlement issues) should be reported immediately.

The scope and depth of the Madoff fraud defies belief and will have significant ramifications for the investment management industry in the future. A central issue for investors and regulators alike will be transparency.

The Lam Group has been structured to provide our clients with an investment management relationship that enjoys the highest degree of transparency and avoids any conflicts of interest. This transparency, combined with the intellectual honesty of using passively-managed asset classes in our asset allocation strategy, is the foundation of our overall investment philosophy and approach.

As our Chief Operating Officer, Tina Lee's efforts at the firm over the past year have allowed us greater efficiencies, and consequently, in 2009 we have the capacity to accept a limited number of new clients. We will continue our policy of considering new clients on a referral-basis only, but have lowered our initial portfolio minimum to $3 million to reflect current market conditions.

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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 12/31/08

Equity Asset Class Category	4Q 2008	2008	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*-22.93%*	*-37.34%*	*- 8.43%*	*+1.00*
US Total Market Fund	-22.74%	-36.68%	-8.27%	+1.00
Domestic Large Cap Stocks				
-S&P 500 Index	*-21.94%*	*-37.00%*	*- 8.36%*	*+1.00*
Domestic Large Cap Value Fund	-27.86%	-40.80%	-11.56%	+0.96
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*N/A*	*N/A*	*N/A*	*N/A*
-Russell 2000 Index	*-26.12%*	*-33.79%*	*- 8.29%*	*+0.90*
Domestic Small Cap Value Fund	-28.70%	-36.79%	-11.81%	+0.88
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*-39.95%*	*-39.20%*	*-12.00%*	*+0.73*
REIT Fund	-38.39%	-37.37%	-11.68%	+0.73
International Real Estate	-33.03%	-51.92%	N/A	N/A
International Large Cap Stocks				
-MSCI EAFE Index	*-19.95%*	*-43.38%*	*-7.35%*	*+0.89*
International Large Cap Value Fund	-24.43%	-46.33%	-7.41%	+0.91
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*-22.15%*	*-47.01%*	*-13.76%*	*+0.66*
International Small Cap Value Fund	-19.38%	-41.68%	- 8.31%	+0.81
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*-27.94%*	*-54.48%*	*-7.07%*	*+0.81*
Emerging Markets Value Fund	-28.51%	-53.94%	-2.56%	+0.83

* 5 yr correlation using monthly data

All data is as of 12/31/08

Fixed Income Asset Class Category	**4Q 2008**	**2008**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	*+ 3.04%*	*+ 6.66%*	*+ 5.95%*	*-0.39*
Short Duration Domestic Inv. Gr. Bond Fund	+ 2.34%	+ 4.08%	+ 4.60%	-0.09
Short Duration Domestic Muni Bond Fund	+ 1.93%	+ 2.90%	+ 3.11%	+0.00
-Lehman Aggregate Bond Index	*+ 4.58%*	*+ 5.24%*	*+ 5.51%*	*+0.12*
Domestic Investment Grade Bond Fund	+ 4.97%	+ 4.82%	+ 5.94%	+0.11
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	*-18.79%*	*-26.17%*	*- 5.34%*	*+0.84*
High Yield Bond Fund	-13.94%	-21.29%	- 4.56%	+0.81
Inflation-Linked Bonds				
-Lehman TIPS Index	*- 3.48%*	*- 2.35%*	*+ 3.06%*	*-0.27*
- Dow Jones AIG Commodities Index	*-30.04%*	*-35.65%*	*- 8.60%*	*+0.37*
TIPS Fund	- 2.87%	- 1.42%	N/A	N/A
Commodities-Linked Fund	-35.68%	-43.33%	-12.06%	+0.40
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*+ 8.80%*	*+10.11%*	*+ 9.49%*	*+0.02*
Non-$ Bond Fund	+ 8.59%	+8.36%	+ 8.08%	+0.06
Emerging Markets Debt				
-JP Morgan EMBI+ Index	*- 6.00%*	*-10.91%*	*+ 1.32%*	*+0.64*
Emerging Markets Debt Fund	- 7.38%	- 13.99%	-0.09%	+0.64

* 5 yr correlation using monthly data

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