The Lam Group
Investment Management

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The Big Picture: Behavioral Finance
It has been a little over a year since Lehman Brothers went bankrupt, Merrill Lynch was acquired, WaMu failed, and Fannie Mae, Freddie Mac and AIG were bailed out by the US government. The crisis was upon us quickly and seemed to encompass all markets. As recently as eight months ago it seemed that the global financial system was on the verge of collapse. These were dark times for everyone and cries from the media that "*this time is different*" and "this is *the worst things have ever been*" were prevalent, and at times irresponsible. For the six-month period (8/31/08 thru 2/28/09), markets fell dramatically and fears rose precipitously on a global basis.

In February of this year, we wrote on these pages that our portfolios had already paid for the risk associated with global financial crisis and that in order to experience the return that comes with greater risk, it was essential to be patient. The following eight months (2/18/09 thru 10/31/09) have been gratifying for our portfolios and a reminder of the importance of discipline to our long-term strategy.

Table 1: Asset Class Returns for (8/31/08-2/28/09) and (2/28/09-10/31/09)

EQUITY ASSET CLASSES	**The Credit Crisis (6 mo) 8/31/08-2/28/09**	**The Recovery (8 mo) 2/28/09-10/31/09**
S&P 500 Index - Domestic Large Cap Stocks	-41.82%	+43.05%
Russell 2000 Index - Domestic Small Cap Stocks	-46.91%	+46.16%
MSCI EAFE Index - International Large Cap Stocks	-44.58%	+57.36%
MSCI EAFE SC Index - International Small Cap Stocks	-45.16%	+72.08%
MSCI EM Index - Emerging Markets Stocks	-47.21%	+86.54%
DJ Wilshire REIT Index - Domestic Real Estate	-61.72%	+75.45%
FIXED INCOME ASSET CLASSES	**The Credit Crisis (6 mo) 8/31/08-2/28/09**	**The Recovery (8 mo) 2/28/09-10/31/09**
BarCap Aggregate Bond Index - US High-Grade Bonds	+ 1.88%	+ 7.59%
BarCap High-Yield Index	-22.39%	+47.68%
BarCap TIPS Index - US TIPS	- 7.47%	+11.17%
DJ UBS Commodities Index - Commodities	-44.03%	+24.55%
Citigroup Non-$ World Bond Index - Non-$ Bonds	- 1.62%	+16.31%
JPM EMBI Global Bond Index - Emerging Markets Debt	-12.74%	+26.90%

Source: Morningstar, JP Morgan, PIMCO and DFA.

If we look at these two periods separately, we can see that the volatility of the last 14 months (8/31/08 thru 10/31/09) was extreme and an illustration of the relationship between risk and reward (the riskiest assets are those with the most volatility). This period was also another example of how difficult it is to predict markets; the explosive rally that began in March of 2009 was as surprising as the severe downturn that began in September 2008.

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However, if we view these two contiguous periods in aggregate (Table 2), we can see that the *cumulative performance of the last 14 months, while disappointing, was not the end of the world.* Investors who had balanced and globally-diversified portfolios who did nothing during the last 14 months were likely to have had better performance than investors who let emotions dictate their investment decision-making process during the meltdown.

Table 2: Asset Class Returns for 14 month period (8/31/08-10/31/09) and 10 years thru 10/31/09

	14 Months	10 Years	
EQUITY ASSET CLASSES	**8/31/08-10/31/09**	**Annualized**	**Total Return**
S&P 500 Index - Domestic Large Cap Stocks	-16.78%	- 0.95%	- 9.10%
Russell 2000 Index - Domestic Small Cap Stocks	-22.41%	+ 4.10%	+ 49.50%
MSCI EAFE Index - International Large Cap Stocks	-12.80%	+ 2.05%	+ 22.47%
MSCI EAFE SC Index - International Small Cap Stocks	- 5.63%	+ 6.96%	+ 95.92%
MSCI EM Index - Emerging Markets Stocks	- 1.32%	+11.49%	+196.75%
DJ Wilshire REIT Index - Domestic Real Estate	-32.84%	+ 9.44%	+146.54%
	14 Months	**10 Years**	
FIXED INCOME ASSET CLASSES	**8/31/08-10/31/09**	**Annualized**	**Total Return**
BarCap Aggregate Bond Index - US High-Grade Bonds	+ 9.61%	+ 6.31%	+ 84.38%
BarCap High-Yield Index	+14.61%	+ 6.51%	+ 87.90%
BarCap TIPS Index - US TIPS	+ 2.87%	+ 7.62%	+108.50%
DJ UBS Commodities Index - Commodities	-30.29%	+ 7.10%	+ 98.62 %
Citigroup Non-$ World Bond Index - Non-$ Bonds	+14.42%	+ 6.71%	+ 91.48%
JPM EMBI Global Bond Index - Emerging Markets Debt	+10.73%	+11.17%	+188.24%

Source: Morningstar, JP Morgan, PIMCO and DFA.

The lesson to be learned from the events of the last 14 months is not that we, or anyone "shouldda, wouldda, or couldda" seen this crisis coming and gone to cash in August 2008 and then gone "all in" to the market in March 2009. Very few investors were able to accomplish both sides of this market timing successfully. *The lesson to be learned from the recent crisis is that panic does not help the investment decision-making process*. While it is possible that individual securities can go to zero in the most dire of circumstances, broadly-defined asset classes cannot. The 10-year data in Table 2 is illustrative of the long-term risk/return characteristics of investment asset classes we consider relevant and important.

*A broadly-diversified portfolio **and** a long term-investment horizon should always defeat panic.*

Given the events of the last 14 months, the academic topic of behavioral finance and its impact on investment decision-making has been widely discussed. A recent DFA presentation on this topic is worthy of attention: http://www.dfaus.com/library/videos/behaviora/.

It is also worth noting that other times in history we have heard the media cry "*this time is different*" and "*this is the worst things have ever been*" were in 1998 with the collapse of hedge fund Long-Term Capital Management (LTCM), and in the late 1980s/early 1990s with the S&L crisis. As many will remember, the LTCM failure was the largest in history and it caused a credit crisis that required (then) unprecedented action by the Federal Reserve to stabilize the global financial markets. Similarly, ten

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years earlier, the savings & loan industry collapsed due to lax lending standards, poor asset/liability management, and inadequate regulation. Over 700 financial institutions with total assets of almost $400 billion (in 1990 dollars) failed, requiring the US Government to intervene in a manner never before seen at the time.

While these two historical events were different in scope and scale to our most recent crisis, in all three instances the global financial system was in uncharted territory and fear and panic were rampant. Nevertheless, the relationship between risk and reward ultimately reasserts itself and history has shown that markets, investor confidence, and the global economies can recover from unprecedented financial system stress. While none of these crises were foreseeable, over the long-term, a properly-balanced and globally-diversified portfolio can navigate these stormy periods and minimize the behavioral impacts of fear and panic.

The Lam Group: The Short and the Long of It

With the historically volatile month of October behind us, November is off to a solid start and we turn our attention to finishing 2009 strongly and uneventfully.

There seems to be a widespread concern with the “inevitability” of higher US interest rates, however the direction of rates and the speed at which they will change is a more complex issue than many people consider.

With short-term US Treasury rates so close to zero, the landscape of risk and return has never been clearer: in order to receive return, you must take risk. As we know, risk can be taken in many forms: credit, interest rate/duration and market (equity) and each of these forms have different return profiles. By keeping short-term interest rates so low, the Fed is trying to force capital back into the equity and capital markets by making it too expensive (no return) to stay in the safest investments. Additionally, low short-term interest rates stimulate the economy, provide liquidity to our recovering banking system and help stabilize the global financial system.

In addition to keeping short-rates low, during the crisis the Federal Reserve bought loans and mortgage assets (known as Quantitative Easing) from banks and bought US Treasuries from the US Treasury to provide liquidity to the global financial system and to stimulate lending. The explosive recovery that all markets have experienced over the last 8 months is an indication that many of the Fed policies implemented during the crisis have been successful. However, as a consequence, the Fed’s balance sheet is bigger than it has ever been.

As rising interest rates can cause capital loss to fixed income holdings, it is unlikely that after a period of extreme auto-gratification (Fed buys what the US Treasury sells), the Fed would make things difficult for itself by raising short-term interest rates. At this stage of the fledgling recovery, the Fed has stated that it is unlikely that they will raise short-term interest rates in the near-term.

While low short-term interest rates have been a tonic for the difficulties and ills of last year, they are not without costs. A weaker US currency and inflationary pressures will be problematic in the future.

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At the longer end of the yield curve, however, it is a different story. The Fed has less influence over longer-term interest rates and market forces play a much larger role in determining the level of these rates. With the growing inflationary pressures and weakening US currency that are the result of the Fed largesse the markets have enjoyed, it is possible that buyers of longer-maturity Treasury bonds (many of whom are foreign central banks) may require higher interest rates to compensate for buying a growing supply of US Treasury bonds. As a consequence, it is possible that longer rates will rise to a larger degree and/or faster than short rates, resulting in a steepening yield curve. While this may be unfavorable for the holders of longer-maturity bonds, a *steep or steepening yield curve* is favorable for the profitability and stability of banks and financial institutions. If 2008 has taught us anything, a stable financial system is of long-term importance and a positive tailwind to any recovery.

However, as long rates rise, the portfolios of many retired investors may be at risk. An "old school" approach to constructing an investment portfolio for retirees included holding the bulk of a portfolio in long-term bonds so the coupon payments immunize (match) future cash flow needs. This approach to retirement investing is particularly risky in periods of rising long rates (capital loss) and/or inflation (loss of purchasing power). In an inflationary environment, even if the bonds are held to maturity (preventing capital loss), the loss of purchasing power could be devastating at the twilight of one's time on earth.

A conservative alternative to the "old school" retirement portfolio strategy would include 1) higher-yielding, short-duration investment-grade bonds (as rates go up, the short-duration bonds mature more frequently than intermediate and long-term bonds and can be reinvested at the higher prevailing rates) and 2) Treasury Inflation Protected Securities (TIPS) which provide long-term protection against inflation with the safety of US Treasury credit risk.

More aggressive asset class additions to combat the withering long-term effects of inflation include international and emerging market bonds (to give a portfolio exposure to strengthening currencies), as well as more traditional inflation-hedging asset classes such as global equities, real estate and commodities.

Given the extreme measures taken to rescue the global financial system from failure last year, it is likely that a weaker US currency and the resulting inflation will represent a larger challenge for investment portfolios in the future.

The Lam Group continues to focus on designing and managing balanced and globally-diversified investment portfolios. 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 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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Our Firm 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.

We continue our policy of considering new clients on a referral-basis only.

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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 10/31/09

Equity Asset Class Category	Oct 09 YTD	12 Mo.	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 Index (Total US Eq. Market)	*+19.03%*	*+11.34%*	*- 6.55%*	*+1.00*
US Total Market Fund	+18.56%	+11.00%	- 6.61%	+1.00
Domestic Large Cap Stocks				
-S&P 500 Index	*+17.05%*	*+ 9.81%*	*- 7.02%*	*+1.00*
Domestic Large Cap Value Fund	+20.02%	+11.76%	-10.45%	+0.97
Domestic Small Cap Stocks				
-Russell 2000 Index	*+14.12%*	*+ 6.46%*	*- 8.51%*	*+0.93*
Domestic Small Cap Value Fund	+20.08%	+ 9.97%	- 10.88%	+0.91
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*+12.32%*	*- 0.26%*	*-16.77%*	*+0.80*
REIT Fund	+12.23%	+ 0.98%	-16.31%	+0.80
International Real Estate	+33.33%	+29.25%	N/A	N/A
International Large Cap Stocks				
-MSCI EAFE Index	*+27.36%*	*+27.72%*	*- 5.22%*	*+0.91*
International Large Cap Value Fund	+33.93%	+35.11%	- 5.26%	+0.93
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*+45.69%*	*+48.74%*	*- 5.50%*	*+0.84*
International Small Cap Value Fund	+37.15%	+41.33%	- 3.61%	+0.86
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*+61.23%*	*+60.25%*	*+ 3.93%*	*+0.83*
Emerging Markets Value Fund	+72.24%	+78.59%	+ 8.67%	+0.87

Source: Morningstar, JP Morgan, PIMCO and DFA.

* 5 yr correlation using monthly data

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All data is as of 10/31/09

Fixed Income Asset Class Category	Oct 09 YTD	12 Mo.	3 Year Annualized	Correlation w/ S&P 500*
Domestic Investment Grade Bonds				
-Barclays 1-3 year Govt Bond Index	*+ 1.55%*	*+ 3.85%*	*+ 5.27%*	*-0.29*
Short Duration Domestic Inv. Gr. Bond Fund	+ 2.02%	+ 3.71%	+ 4.06%	+0.01
Short Duration Domestic Muni Bond Fund	+ 2.69%	+ 4.31%	+ 3.21%	+0.08
-Barclays Aggregate Bond Index	*+ 6.24%*	*+13.79%*	*+ 6.35%*	*+0.24*
Domestic Investment Grade Bond Fund	+13.40%	+20.11%	+ 9.16%	+0.36
Domestic High Yield Bonds				
-Barclays High Yield Bond Index	*+51.65%*	*+48.10%*	*+ 5.46%*	*+0.76*
High Yield Bond Fund	+34.47%	+36.78%	+ 3.45%	+0.73
Inflation-Linked Bonds				
-Barclays TIPS Index	*+10.82%*	*+17.15%*	*+ 6.10%*	*+0.29*
- Dow Jones UBS Commodities Index	*+12.64%*	*+ 0.10%*	*- 5.36%*	*+0.42*
TIPS Fund	+10.38%	+17.70%	+ 6.33%	+0.36
Commodities-Linked Fund	+31.52%	+19.35%	- 3.18%	+0.46
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*+ 6.83%*	*+19.26%*	*+ 9.81%*	*+0.23*
Non-$ Bond Fund	+ 9.56%	+21.45%	+ 7.93%	+0.35
Emerging Markets Debt				
-JP Morgan EMBI+ Index	*+26.45%*	*+39.66%*	*+ 6.87 %*	*+0.69*
Emerging Markets Debt Fund	+28.33%	+42.05%	+ 6.12%	+0.71

Source: Morningstar, JP Morgan, PIMCO and DFA.

* 5 yr correlation using monthly data

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