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The Big Picture: The Bond Bubble
The term "bubble" as it pertains to financial assets is frequently overused in the financial media.

During the internet bubble in 1999-2000, droves of investors abandoned the idea of disciplined asset allocation and poured into US technology/growth stocks with no more due diligence than watching a few hours of CNBC. This modern-day gold rush saw investors borrowing money to seize this "once-in-a-lifetime" "game changer".

During the housing bubble that followed (2003 thru 2007), home buyers and speculators, taking advantage of low interest rates, availability of unprecedented amounts of leverage and questionable lending standards, bought into residential home markets that many believed "could only go up".

It is notable that the term bubble as it pertained to the internet stock and housing markets was primarily used by the media only after these bubbles burst. Prior to the bubble bursting, the media thought these markets were rising because of the "new paradigm" or the "magic of securitization".

Not only is the financial media a poor predictor of bubbles, but many argue that they help create bubbles by generating enthusiasm, bordering on hysteria, for these "hot" markets. Regardless of the media's role, it would be fair to say that the existence of asset bubbles and the use of excessive leverage are intertwined and perhaps even correlated.

In the financial media today, the phrase "bond bubble" is being used with greater frequency. With the massive inflow of funds into the bond markets since the global financial crisis of 2008-09 and the steady decline in interest rates, many media pundits trying to regain lost credibility are predicting the impending and obvious collapse of the bond market.

With interest rates so low, how can they not rise?

Whatever the reason for the torrential inflow into bonds, it would seem unlikely that bond investors are using leverage to buy US Treasury 10 year notes that yield only 2.50%.

Without the presence of excessive leverage, can a bubble exist?

Unlikely. However, there is a basic misunderstanding of bond market mathematics that causes unwarranted fear when it comes to the possibility, and perhaps the inevitability, of rising interest rates.

Bond prices have an inverse relationship to interest rates: Bond prices fall when interest rates rise.

However, the magnitude of bond price movements depend a great deal on how much and how fast interest rates rise, and also upon the length of the bond's duration*.

The longer the duration of a bond, the more sensitive its price is to changes in interest rates*

Table 1: Duration of Current Issue US Treasury Bills, Notes and Bonds

As of 9/30/10	**1 Yr Bill**	**2 Yr Note**	**5 Yr Note**	**10 Yr Note**	**30 Yr Bond**
US Treasury Issue	9/22/2011	0.375% of 9/12	1.250% of 9/15	2.625% of 8/20	3.875% of 8/40
Market Yield	***0.26%***	***0.43%***	***1.27%***	***2.51%***	***3.69%***
Duration	**0.98 yrs**	**1.99 yrs**	**4.86 yrs**	**8.70 yrs**	**18.07 yrs**

For purposes of this discussion, lets use the term *bond* when discussing all US Treasury fixed income securities with the understanding that securities with a maturity of 1 year or less (Bills) are considered short-duration bonds, securities with a maturities of 1 to 5 years are considered short-to-moderate duration bonds, and securities with maturities of 10 to 30 years are considered long-duration bonds.

Table 2: Bond Price Change for an Immediate 100 bp (1%) Increase in Interest Rates

Bond Price Risk	**1 Yr Bill**	**2 Yr Note**	**5 Yr Note**	**10 Yr Note**	**30 Yr Bond**
-if Yield rises by 100bps (1%)	**-0.97%**	**-1.99%**	**-4.83%**	**-8.73%**	**-16.38%**

As we can see in Table 2, for an immediate 100 bp (1%) increase in interest rates, bond price changes vary significantly depending on a bond's duration. A short-duration bond, such as a 1 year Bill, loses less than 1% of its value despite this sudden move in interest rates. This security will also mature at par within a year and the investor will have the opportunity to reinvest the principal at the higher interest rates. *Short and moderate duration (1 to 5 year) securities have meaningfully less price sensitivity to rising interest rates than longer duration securities, and have more frequent opportunities to reinvest their principal at higher rates.*

On the other hand, longer-duration securities (10 to 30 years) have much more price sensitivity to movements in interest rates. For the same 100 bp immediate increase in interest rates, the price of a US Treasury 10 yr note declines over 8% while the price of a US Treasury 30 yr bond declines over 16%. That is serious price volatility.

Academic studies have shown that investors may not be adequately compensated for bearing interest rate risk with longer-duration bonds ***whereas investors in short-to-moderate duration investment grade bonds (when purchased without leverage) have a relatively low likelihood of experiencing bubble-like behavior.***

* for a detailed definition of duration, please contact us. However for the purposes of this discussion, bond duration and bond maturity mean essentially the same thing.

It is worth noting that an immediate 100bp increase in interest rates would be a negative surprise to both the bond and the stock markets; in this unlikely scenario, short-to-moderate duration bonds would likely outperform all other asset classes. ***Because of the limited price volatility of short-to-moderate duration bonds, our managed portfolios generally limit our domestic investment-grade bond exposures to institutional bond mutual funds with these duration characteristics.***

In recent years, the Fed has moved the rates under its purview (Fed Funds and Discount Rate) in increments of 25 basis points (0.25%) if at all, in its monthly meetings. To move rates 100bps (1%) might require 4 consecutive Fed meetings (four months) or some sort of global disaster such as the Lehman Brothers bankruptcy in September 2008 or the WTC attack in September 2001. Historically, one time moves of this magnitude have been decreases in interest rates rather than increases to address some level of emergency in the financial system. It is likely that any upward move in interest rates initiated by the Fed will be implemented in a slow, measured, and deliberate manner.

Any current conversation regarding the bond market and the potential direction of interest rates has to include a discussion of Quantitative Easing.

What is Quantitative Easing?

As we know, the Fed has explicit control over short-term interest rates via its implementation of monetary policy and has kept those rates near zero since October 2008 to provide stimulus to the global financial system. The Fed has stated that it will continue its accommodative monetary policy for the foreseeable future and it is unlikely this policy will change until meaningful evidence of economic growth is realized and the recovery has traction.

The strategy of keeping short-term interest rates low helps banks and financial institutions borrow more cheaply so they can make loans. Unfortunately, loan demand and origination is not happening as quickly as policymakers would like. Part of the reason for this is the steepness of the yield curve. As we can see from Table 1, interest rates in the longer maturities are demonstrably higher than interest rates in the short maturities.

While the Fed does not have explicit control over longer-term interest rates, they would like to give businesses more incentive to borrow for longer terms. To achieve this, the Fed has embarked on a program known as Quantitative Easing (QE) to force longer-term interest rates lower by purchasing large amounts of longer-duration US Treasury securities and agency mortgages in the open market. By forcing interest rates down in the longer maturities, the Fed expects this will stimulate new longer-term lending to businesses and increase overall economic activity.

Through continued accommodative monetary policy and an unprecedented second round of quantitative easing (QE2) the Fed is demonstrating their seriousness in stimulating the economy.
As a consequence, despite the extremely low level of interest rates, it is unlikely that the Fed will raise interest rates until there is real and ongoing evidence of economic recovery.

The principal risks of these stimulative policies are a weaker US currency and the inflationary pressures that inevitably follow. It is possible that the Fed welcomes an inflationary environment for a reasonable period to stem the deflationary pressures our economy has been experiencing since 2008.

There is a widespread and common misconception that inflation causes interest rates to increase. This is simply not true. Conversely, however, low interest rates and accommodative monetary policy can cause inflation. Raising interest rates is one of the tools that is commonly used to combat rising/unwanted inflation.

An important question to ask is why would or should interest rates increase? There are good and bad reasons that might cause interest rates to go up.

While the Fed is currently trying to generate inflation, if sustainable improvements in the economy and unemployment are realized, it is reasonable that the Fed would allow short-term interest rates to rise (and end the QE program). In this favorable scenario it is likely that the Fed would orchestrate a slow, deliberate and well-telegraphed message of this policy change.

On the other hand, growing inflationary pressures and a weakening US dollar could cause a crisis of confidence leading to capital flight from the US. To stem the flight of foreign capital, sudden and perhaps unexpected increases in interest rates could be necessary to defend our currency (this happened in 1973-74 and 1979-81). This increase in rates could be driven by market forces (investors demanding more yield to buy our debt) and/or actions by the Fed.

It continues to be our opinion that predicting interest rates and bond prices is no easier than predicting stock prices or the direction of the commercial real estate market. Making decisions based on what appears to be a certain outcome at the time can often prove costly. Many investors who reconfigured their portfolios in anticipation of higher interest rates this year and have penalized their results while they were waiting. ***Instead of seeking to predict the unpredictable, investors are much more likely to enhance their results by focusing on the elements they can control – risk exposure (including duration), diversification and minimizing costs and taxes.***

The Practicality of Bond Ownership
We are often asked if it is better to own individual bonds or bond mutual funds for our portfolio's fixed income exposure. To answer this question, it is important to remember why we own the investment grade bond asset class in the context of a balanced portfolio strategy. While we own riskier investments like stocks and real estate for the possibility of higher long-term returns, allocations to the investment-grade bond asset class are generally held to reduce the risk of the overall portfolio. The two most important factors to consider when taking this exposure are:

Liquidity: When it comes to bonds, size matters. The biggest trading cost is transaction size, as there are significant economies of scale when it comes to purchasing individual bonds. When investing in individual bonds, as trade size decreases, the cost of investing increases (retail pricing/execution). The cost of liquidity in individual bonds is substantial.

Safety: The diversification of credit risk is important in a bond portfolio. Just as with equities, diversification reduces risk. Investment theory and common sense argue that investors are not compensated for idiosyncratic (unsystematic) risk. Poorly diversified investors who were unfortunate enough to own concentrated positions in the investment-grade bonds of BP were reminded of this recently.

Constructing a bond portfolio with sufficient diversification to protect from unsystematic risk is difficult and expensive to do with individual bonds.

It is because of the limitations imposed by liquidity and safety that we believe institutional bond mutual funds with specific parameters regarding duration (short-to-moderate) and credit quality (BBB or better) are the most efficient way for individual investors to achieve their investment-grade fixed income exposure.

The Lam Group: Embracing Risk
To date, 2010 has been an interesting year. Despite worries of deflation, the perceived inevitability of rising interest rates, the debt problems in Europe leading to another global financial crisis, and the impending collapse of the commercial real estate market, our balanced and globally diversified portfolios have persevered nicely. We hope to finish the year successfully and uneventfully.

With short-term interest rates so close to zero, the landscape of risk and return has never been clearer: *investors must take risk in order to earn return.* A strong link between risk and return appears in all properly functioning capital markets.

When investing in stocks, bonds, or other asset classes, investors must accept more risk to pursue a higher potential return. Risk can be taken in many forms: credit risk, duration/term risk (longer maturities) and capital structure risk (equity versus debt) and each of these forms of risk have different return profiles.

- By keeping short-term interest rates so low, the Fed and other central banks are trying to force capital back into the equity and capital markets by making it too expensive (minimal returns) to stay in the safest investments.

- While there are those who seek the safety of cash to avoid the *explicit risk of capital loss*, the holders of zero-yielding cash/money market funds have the *implicit risk of losing future purchasing power to the ravages of inflation*.

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, Maryland, New York, and New Jersey. We offer both investment management and portfolio consulting services for taxable investors, family offices, and foundations.

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

Nelson J. Lam
The Lam Group, Inc.
P.O. Box 850
Lake Oswego, OR 97034
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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 10/31/10

Equity Asset Class Category	YTD 10/2010	12 Mo.	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 Index (Total US Eq. Market)	***+ 9.54%***	***+19.04%***	***- 5.55%***	***+1.00***
Domestic All Cap Fund	+10.55%	+20.80%	- 4.95%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	***+ 7.84%***	***+16.52%***	***- 6.49%***	***+1.00***
Domestic Large Cap Value Fund	+10.36%	+19.71%	- 7.16%	+0.98
Domestic Small Cap Stocks				
-Russell 2000 Index	***+13.58%***	***+26.58%***	***- 3.91%***	***+0.93***
Domestic Small Cap Value Fund	+14.75%	+27.69%	- 4.39%	+0.92
Real Estate Investment Trusts (REITs)				
-DJ Wilshire US REIT Index	***+24.71%***	***+42.63%***	***- 5.93%***	***+0.80***
Domestic REIT Fund	+25.40%	+43.21%	- 5.23%	+0.88
-S&P Global REIT (ex-US)	***+14.40%***	***+16.43%***	***-12.38%***	***+0.87***
International Real Estate	+15.77%	+18.96%	-12.42%	N/A
International Large Cap Stocks				
-MSCI EAFE Index	***+ 4.72%***	***+ 8.36%***	***- 9.60%***	***+0.91***
International Large Cap Value Fund	+6.54%	+10.93%	- 9.85%	+0.93
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	***+13.38%***	***+14.23%***	***- 7.56%***	***+0.85***
International Small Cap Value Fund	+ 8.23%	+10.08%	- 7.80%	+0.88
Emerging Markets Equity				
-MSCI Emerging Markets Index	***+11.75%***	***+20.95%***	***- 6.15%***	***+0.83***
Emerging Markets Value Fund	+16.49%	+30.04%	- 1.53%	+0.86

Source: Morningstar, JP Morgan, PIMCO and DFA. * 5 yr correlation using monthly data

All data is as of 10/31/10

Fixed Income Asset Class Category	**YTD 2010**	**12 Mo.**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Barclays 1-3 year Govt Bond Index	***+ 2.78%***	***+ 2.64%***	***+ 4.24%***	***-0.30***
Short Duration Domestic Inv. Gr. Bond Fund	+ 5.97%	+ 6.52%	+ 5.30%	-0.01
Short Duration Domestic Muni Bond Fund	+ 1.74%	+ 2.73%	+ 2.98%	+0.02
-Barclays Aggregate Bond Index	***+ 8.33%***	***+ 8.01%***	***+ 7.23%***	***+0.19***
Domestic Investment Grade Bond Fund	+11.00%	+11.43%	+10.82%	+0.28
Domestic High Yield Bonds				
-Barclays High Yield Bond Index	***+14.41%***	***+19.35%***	***+ 9.46%***	***+0.74***
High Yield Bond Fund	+14.51%	+23.33%	+ 9.47%	+0.82
Inflation-Linked Bonds				
-Barclays TIPS Index	***+ 9.84%***	***+10.42%***	***+ 7.44%***	***+0.27***
TIPS Fund	+10.65%	+11.29%	+ 7.94%	+0.37
-Dow Jones UBS Commodities Index	***+ 5.93%***	***+11.82%***	***- 6.35%***	***+0.51***
Commodities-Linked Fund	+14.84%	+22.17%	- 1.59%	+0.53
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	***+ 8.89%***	***+ 6.40%***	***+ 8.49%***	***+0.25***
Non-$ Bond Fund	+ 3.90%	+ 4.08%	N/A	N/A
Emerging Markets Debt				
-JP Morgan EMBI Global Diversified Index	***+16.36%***	***+18.06%***	***+10.06 %***	***+0.65***
Emerging Markets Debt Fund	+16.53%	+18.53%	+ 9.28%	+0.68

Source: Morningstar, JP Morgan, PIMCO and DFA. * 5 yr correlation using monthly data