The Lam Group

Investment Management

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The Big Picture: I Read the News Today, Oh Boy…

The current market environment has investors confused and looking for answers.

What should investors do with all this bad news?

Whether it be the credit downgrade of US Treasury securities, fears of a double dip recession, and/or uncertainty surrounding the European banking system, it is hard to pick up a newspaper or watch CNBC and not be concerned. With all these problems being highlighted in the news, it may seem natural to think that it is time to exit, or at least reduce exposure to risky assets in your portfolio.

Playing on these emotions, we often hear the refrain in the financial media that there is something fundamentally unusual about this economic period and/or that we are now in uncharted waters ("this time is different"). It is important to remember that crises only occur in periods of uncharted waters (if we weren't in uncharted waters, no one would consider it a crisis) and that crises are NOT a sell indicator. As the late investor and market historian Peter Bernstein once said,

"If you don't know what's going to happen, don't structure your portfolio as though you do."

Being an intelligent investor also means realizing that it really is NOT different this time and ***the fundamental relationship between risk and return has not changed***. By the time that you read about "news" in the media, this information is already reflected in asset prices. Furthermore, economic forces may not impact financial markets in obvious ways. Recent history gives us some good examples of the unpredictability of markets:

- In July, predictions that US Treasury securities would lose its triple-A status were followed by a strong rally in US Treasury prices soon after the S&P credit downgrade.
- Over the last year, many have predicted that US interest rates would rise meaningfully and that long-duration bond positions were in a bubble. Interest rates have in fact declined.

It is worth noting that fixed income asset classes (led by longer-duration investment grade bonds and TIPS) are this year's top performers (thru August 2011).

For investors with long-term investment horizons, market volatility is an accepted element of the strategy. During times of steep market declines, ***the portfolio has already paid for the risk, it only make sense for investors to wait for the return.***

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We continue to believe that it is impossible to consistently predict what the markets will do and that securities prices already reflect all market fears and aspirations. If the 2008-09 crisis has taught us anything, it is important not to panic during periods of high volatility. Trying to time the market and trying to pick individual securities or sectors is more likely to result in disappointing results and increased transactions costs and tax expenses.

In hindsight, buying opportunities tend to occur during periods of widespread negative news and investor sentiment. Higher investor uncertainty and greater risk make great fertilizer for higher expected returns. Periods of extreme investor distress that ended up being opportunities:

- the global financial crisis of 2008-09,
- the world events that impacted 2001-02 (dot com burst/Enron fraud/terrorist attacks of 9/11)
- the LTCM collapse in 1998
- the S&L crisis in 1989-90
- Black Monday in 1987

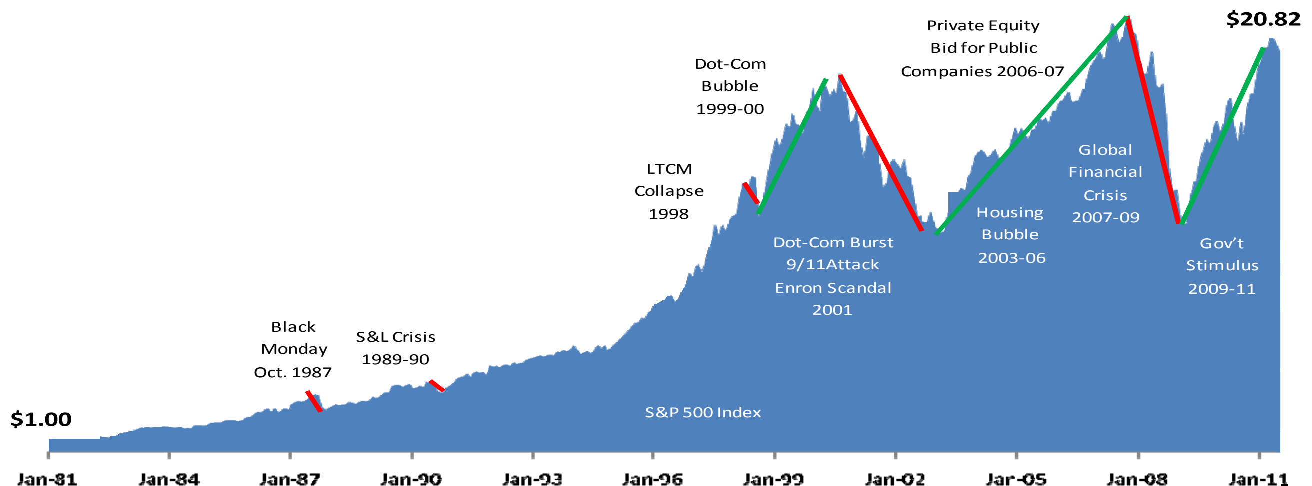
Widespread negative sentiment is often a sign of these opportunistic times.

With the same hindsight, the best time to sell/rebalance/reduce portfolio risk occur during carefree times of investor exuberance. Less uncertainty and greater investor comfort can result in a herd mentality leading to buying/increasing risk after asset prices have already risen. These periods have included:

- the private equity bid for public companies during 2006-07
- the housing bubble of 2003-06
- the internet bubble 1999-00

Widespread investor enthusiasm and the presence of low-cost leverage is often a sign of these carefree, but potentially more volatile times.

Growth of $1: S&P 500 January 1981-August 2011



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The counterintuitive nature of risk and reward makes it difficult to make dispassionate investment decisions especially with the constant noise of the financial media trying to predict the direction of the markets. The presence of 24-hour financial news and data makes all markets more efficient as more investors have better news, more quickly.

"…and while the news was rather sad, I just had to laugh…"
John Lennon, *A Day in the Life*

With the stress of uncertain times and the excitement of the most certain of times, having an established portfolio asset allocation strategy that is consistent with one's risk/return preferences is a much more reasonable approach to volatile markets.

As we have stated many times, *in practice, buying low and selling high is never easy or obvious*. Investors who remain disciplined with respect to their investment approach are likely to be rewarded over time. The equity market declines this summer have caused our portfolios to become underweighted in stocks and overweighted in bonds. We expect to rebalance the portfolios opportunistically.

2011 Mid-Year Overview:
The equity markets have been volatile since the market highs in April 2011; the equity market declines in August have been particularly breathtaking. While some of the recent decline is markets undoubtedly "cooling off" after the 24 months of strong equity market performance since the lows reached in March 2009, we are again reminded that confidence in the global financial system, whether at home or abroad, is essential to market stability.

The perceived banking system problems in Europe, initiated by debt problems in Greece and potentially other countries, have shaken investor confidence once again. Due to the nature of global bank counterparty relationships, a problem in one part of the world can become a global problem in relatively short order. While the level of these problems was unexpected, the European problems are not new or unsolvable issues.

Fortunately, the playbook for dealing with these sorts of challenges and the reaffirmation of investor confidence were written during the salvation of our own banking system during the 2008-09 crisis. However, it may take additional time for the details and nuances of these processes to be adequately translated into other languages. Furthermore, the European Central Bank (ECB) is run to meet the monetary policy needs of its 17 member countries each of which has independent fiscal policies. While the ECB is more complicated than our Federal Reserve, given the global, and interconnected nature of the financial system, a solution to the debt problems in Europe will ultimately be found.

It is worth noting that globally, the amount of leverage in the financial system is significantly lower than during the 2008-09 crisis which should make the degree and scale of Europe's problems more manageable. As Yogi Berra once said (and we have said many times):

"its déjà vu all over again"

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The European discussion of fiscal imprudence and the pending implosion of the financial system sounds hauntingly familiar. In fact, it was only two years ago that many investors, led by the financial media, were convinced of the inevitable failure of the equity markets and were preparing for the next Great Depression. Over the same period, many "market experts" felt that interest rates were poised to rise (shorting the long bond was considered a sure thing) and commercial real estate was the next expected nail in the coffin.

However, the sequel to the Great Depression opened to unfavorable reviews and domestic interest rates have fallen over the last 24 months. *Ironically, global commercial real estate and Japanese small cap stocks are the only equity asset classes with a positive return for 2011; these unlikely equity sectors have outperformed all other equity asset classes this year.* So much for the predictions of media pundits and market experts. It is certainly not the first time that markets have performed well in the midst of looming crises and bad news, and likely not the last.
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The Lam Group: Invisible and Unconflicted

An unconflicted, independent investment manager is only visible to those who are looking for one.

As our clients and friends know, we started The Lam Group almost 10 years ago because Tina and I could not find a suitable investment management firm to manage our own personal assets. Armed with a strong capital markets framework borne out of our combined 20 years of professional experience in institutional markets on Wall Street, we knew what we wanted but were unable to find it. The most important elements we were looking for was an independent firm with a business model that was unconflicted with the interests of their clients. Why was an experienced and knowledgeable investment advisor with a transparent and academically-tested investment strategy so hard to find?

As we could not find one, we decided to become one.

Over the last 10 years, we have grown organically and have over $225MM AUM with fewer than 50 clients. We have never done any advertising and have generally met new clients as referrals from existing clients, as well as leading tax advisors and estate attorneys. We were fortunate to be the subject of a full page article in the Wall Street Journal on February 7, 2011 (page R5 of the physical paper). The article (written by WSJ reporter Shefali Anand) was based on the Randomness of Asset Class Returns research we had published earlier this year and really captured the essence of our globally-diversified and balanced portfolio strategy.

The reaction to the article was been overwhelming and indicates that many others are looking for what Tina and I could not find 10 years ago. The Lam Group is currently accepting a limited number of new clients who believe in our diversified, multiple-asset class investment management approach and embrace our use of passive investment strategies.

The Lam Group focuses 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.

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The Lam Group
Investment Management

Our Firm has been structured to provide our clients with an investment management relationship that enjoys the highest degree of transparency and avoids 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.

The Lam Group is an independent, fee-only, SEC-registered investment advisory firm with clients in Oregon, Washington State, California, Texas, Maryland, Virginia, Florida, Pennsylvania, Connecticut, New York, and New Jersey. We offer both investment management and portfolio consulting services for taxable investors, family offices, endowments and foundations.

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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 8/31/11

Equity Asset Class Category	**YTD 2011**	**12Mo**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-DJ US Total Market Index	***- 2.59%***	***+19.15%***	***+1.18%***	***+1.00***
Domestic All Cap Fund	- 3.67%	+19.81%	+1.41%	+1.00
Domestic Large Cap Stocks				
-S&P 500 Index	***- 1.77%***	***+18.50%***	***+0.54%***	***+1.00***
Domestic Large Cap Value Fund	- 5.27%	+17.43%	-0.91%	+0.98
Domestic Small Cap Stocks				
-Russell 2000 Index	***- 6.54%***	***+22.19%***	***+0.83%***	***+0.94***
Domestic Small Cap Value Fund	- 8.98%	+22.15%	+1.86%	+0.92
Real Estate Investment Trusts (REITs)				
-DJ US Select REIT Index	***+ 6.76%***	***+19.79%***	***+1.65%***	**+0.80**
Domestic REIT Fund	+ 6.30%	+19.12%	+2.53%	+0.80
-S&P Global REIT (ex-US)	***+ 3.05%***	***+20.14%***	***+0.81%***	***+0.88***
International Real Estate	+ 3.78%	+21.06%	+1.38%	N/A
International Large Cap Stocks				
-MSCI EAFE Index	***- 6.02%***	***+10.01%***	***+2.96%***	***+0.92***
International Large Cap Value Fund	- 9.46%	+ 7.72%	-2.32%	+0.94
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	***- 5.70%***	***+17.44%***	***+2.90%***	***+0.87***
International Small Cap Value Fund	- 7.68%	+15.56%	+1.63%	+0.89
Emerging Markets Equity				
-MSCI Emerging Markets Index	***- 8.55%***	***+ 9.07%***	***+5.05%***	***+0.83***
Emerging Markets Value Fund	-12.45%	+ 6.27%	+6.72%	+0.86

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

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All data is as of 8/31/11

Fixed Income Asset Class Category	YTD 2011	12Mo	3 Year Annualized	Correlation w/ S&P 500*
Domestic Investment Grade Bonds				
-Barclays 1-3 year Govt Bond Index	***+ 1.49%***	***+ 1.53%***	***+ 2.98%***	***-0.32***
Short Duration Domestic Inv. Gr. Bond Fund	+ 1.62%	+ 2.04%	+ 4.84%	+0.47
Short Duration Domestic Muni Bond Fund	+ 2.42%	+ 1.36%	+ 2.80%	-0.02
-Barclays Aggregate Bond Index	***+ 5.88%***	***+ 4.62%***	***+ 7.23%***	***+0.13***
Domestic Investment Grade Bond Fund	+ 3.45%	+ 3.28%	+ 9.20%	+0.28
Domestic High Yield Bonds				
-Barclays High Yield Bond Index	***+ 1.95%***	***+ 8.39%***	***+11.95%***	***+0.75***
High Yield Bond Fund	- 1.35%	+ 9.80%	+11.84%	+0.83
Inflation-Linked Bonds				
-Barclays TIPS Index	***+10.85%***	***+10.80%***	***+ 6.81%***	***+0.24***
TIPS Fund	+11.82%	+11.93%	+ 7.30%	N/A
-Dow Jones UBS Commodities Index	***+ 1.29%***	***+25.81%***	***- 4.51%***	***+0.54***
Commodities-Linked Fund	+ 7.53%	+34.77%	- 0.19%	+0.55
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	***+ 9.23%***	***+ 11.21%***	***+ 8.71%***	***+0.26***
Non-$ Bond Fund	+ 4.45%	+ 8.44%	+ 3.73%	N/A
Emerging Markets Debt				
-JP Morgan EMBI Global Diversified Index	***+ 7.25%***	***+ 7.02%***	***+10.66 %***	***+0.62***
Emerging Markets Debt Fund	+ 5.80%	+ 6.13%	+10.06%	+0.65

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

Disclaimer:
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