WIAD Newsletter

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"There is nothing dumber than betting against America, it hasn't worked since 1776"

Warren E. Buffett, The Wall Street Journal 9/24/01

In This Issue

What I Am Thinking - Big Picture

The events of September 11, 2001 were tragedies of previously unthinkable proportions. We extend our sympathies and condolences to all who lost colleagues and loved ones.

I had intended this issue of the WIAD Newsletter to serve as an end-of-the-quarter review of the strategies and investments ideas discussed earlier this quarter. Given the events of September 11th and their near-term effects on the markets, it would be fruitless to attempt this sort of discussion at this early stage of the crisis. I will attempt this review in a future newsletter, at a time when things are more settled than they are now.

In the near term, short-term interest rates around the world are going down as the central banks continue to flood the markets with liquidity and investors sell equities and buy US Treasury Bills and Notes in a "flight to quality". As a result, while the US Treasury yield curve steepens, interest rates across the yield curve should decline. *This is a good time to refinance a mortgage.* Since the attack, it is worth noting that stocks of residential mortgage and home finance companies like Fannie Mae (FNM) and Washington Mutual (WM) have outperformed the broad domestic equity market.

In the longer term, *the steepening of the US Treasury yield curve will be driven by long-maturity US interest rates going up.* Federal disaster relief has already consumed our original budget surplus and the costs to rebuild, defend and finance our nation will cost additional billions. As a result, the US Treasury will be a larger borrower in the foreseeable future than it has been in the recent past. This increased Federal borrowing will cause longer-term interest rates to rise and may have a "crowding-out" effect on corporate borrowers, causing *corporate bond yield spreads to widen.* Additionally, insurance companies (life, property and casualty, and reinsurance) may need to liquidate large quantities of longer-maturity fixed income positions to pay policyholders, which may also contribute to the corporate yield spread widening and increasing interest rates in the long-end of the yield curve.

A steeply sloped treasury yield curve may signal future inflation and may imply an investor perception of a greater risk premium in our country. This is something to start thinking about.

Times of high volatility and high emotional stress are not ideal occasions to make big decisions. I believe this to be true in the case of *investment management* as well other aspects of adult life.

With the global markets in the depressed and uncertain state they are in, I believe panicking and/or outright selling would be a mistake in the long run. That being said, from a *portfolio management* standpoint, I think it may be a good time to rebalance and optimize one's portfolio and revisit the idea of planning and asset allocation.

What I Am Thinking – Risk Premium

The Attack on September 11th may or may not have permanently changed the markets and how they trade, however, the event did reintroduce the concept of risk premium and how we perceive this premium to value the markets. Risk premium can be defined as the amount of additional return an investor requires to participate in a market or sector. Investor perception of risk premium can vary and is usually inversely correlated to investor confidence.

A greater market risk premium can manifest itself in many ways. In the fixed income market, risk premium can be measured by i) the steepness of the yield curve and/or ii) yield differential (spread) compared to a "risk free" US Treasury yield curve. In a higher risk premium market, *the yield curve steepens* (how much more does a 30 year bond have to yield compared to a 2 year bond from the same issuer for an investor to accept the additional risk of holding it?) and *yield spreads widen* (how much more does a AAA-rated corporate bond need to yield than a comparable maturity treasury for an investor to accept the additional risk of holding it?). While other factors such as supply and demand can also affect the shape of the curve and yield spreads, I believe the fixed income market is currently telling us that the risk premium for investors has increased.

In the equity market, risk premium is more difficult to measure. Perhaps one way to quantify risk premium is to look at price/earnings (P/E) ratios. In a market where investors perceive a higher risk premium, the P/E ratio of equities should be lower than during times of lower perceived risk premiums. For example, there has been no period in recent history when P/E ratios of domestic large-cap growth stocks were higher than in the late '90s. During that period, phenomenal revenue growth was unquestioned and the perception of economic and geo-political risk was almost non-existent. In fact, on some large-cap (internet) stocks, their P/E ratios were infinite as these stocks had no earnings and yet investors couldn't buy enough. Based on investor behavior, there was virtually no risk premium perceived in the market in the late '90s.

Given the current global security and economic situation, an argument can be made that investors are requiring a greater risk premium in the equity markets today. This greater risk premium may manifest itself in a general lowering of P/E ratios investors consider acceptable for equity investments. The possibility of lower acceptable P/E ratios will more negatively affect growth-oriented equity strategies more than value-oriented strategies. This is something to consider when making growth vs value asset allocation decisions.

While it is impossible to forecast how long this risk premium will affect the market, I believe it is safe to say that the carefree days of the late '90s are long gone.

What I Am Recommending

The Intelligent Asset Allocator by William J. Bernstein

"Market timing and security selection are obviously important. The problem is that nobody achieves long-term success in the former, and almost nobody in the latter. Asset allocation is the only factor affecting your investments you can actually influence."

William J. Bernstein, Author

The Intelligent Asset Allocator

Any discussion of financial planning and investment management requires a basic understanding of the concept of asset allocation. This is the best book available on the subject of asset allocation. *The Intelligent Asset Allocator* is easy to read, straightforward and written for the educated layperson. The first two chapters of the book are available at: www.efficientfrontier.com. Consider these two chapters required reading for the next WIAD Newsletter.

September Investment Results:	**September**	**3Q2001**	**YTD**
NJL Equity/Income Aggregate	-8.76%	-14.44%	-16.17%
S&P 500 (including dividends)	-8.08%	-14.68%	-20.39%
Russell 3000 (including dividends)	-8.82%	-15.62%	-20.78%
MSCI World (in US $, price only)	-8.92%	-14.64%	-24.17%

Note: The NJL Equity/Income Aggregate is a multi-cap global equity composite that is reflective of my aggregate investment portfolio's performance. The composite returns are comprised of over 99% global equities and cash and less than 1% domestic fixed income and include taxable and tax-deferred portfolios. The composite returns are unaudited and are calculated using AIMR Performance Measurement guidelines.

Political Rhetoric and Defense Spending - An Investor's View

Since the September 11th Attack, the political rhetoric regarding national defense and defense spending has taken a higher profile. While I do not like to participate in political discussions, my investment instincts tell me that, as far as national security goes, we need to: *Pick the low-lying fruit first.*

What I mean by this is the following: Things like missiles and missile defense are very expensive. I am quite certain this is true, and while I am not an expert, I would imagine things like improving airport security and international terrorist intelligence are less expensive. If we assume that our country's human and capital resources are finite, let's allocate these limited resources to less expensive programs like improving airport security and international terrorist intelligence before we spend big bucks on other more expensive programs. In short, *let's make attacking the United States a high-capitalization game.*

If all one needs to commit a senseless act of mass destruction is an economy-class ticket on a fully-fueled jumbo jet, it is unlikely that person or group is going to commit the capital and territorial resources and human efforts to necessary to build or acquire missile or nuclear capabilities. While I do not question the might and overall abilities of our military forces, I do think we must first secure our country's safety on a much more basic level.

By allocating and successfully implementing our resources to relatively inexpensive programs such as airport security and intelligence, it will force our enemies to look to alternative and hopefully more expensive ways to attack us. By forcing these enemies to higher capitalization platforms, the increase in required funding and overall sophistication will thin their ranks and make it easier for us to track them.

By spending billions on missile defense systems and other unproven defensive and military technologies, we may exhaust our capital resources at the expense of other basic and necessary security platforms such as airport security and terrorist intelligence.

Summary

In last month's Newsletter, I thought mutual fund selling was going to be high going into October. With the 9/11/01 terrorist attack, we have seen institutional and retail selling beyond the scope of what I had envisioned for mutual fund year-end.

As a result, I believe there is the risk that taxable distributions from mutual funds this year will be very high. Tax-loss harvesting in 2001 will be as important as it was last year. Check your basis, call your accountant, and just do it! It will be too late in April.

The only nice thing about wars is that they always end. The question really becomes when?

Sincerely,

Nelson J. Lam
The Lam Group
October 9, 2001

Next Month:

- Asset Allocation - A Beginner's Guide
- Inflation Protected Bonds and Savings Bonds
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The archives for the WIAD Newsletter are available at: www.thelamgroup.com/wiad.htm