The Lam Group
Investment Management

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What I Am Thinking - Big Picture
As we discussed in the last Newsletter, the equity markets (globally) were going to get worse before they got better. There is no joy in being right. With the growing potential for war with Iraq, the increased fear of terrorist activity against the United States, the disappointments in company earnings and the overall erosion of investor confidence in corporate America, the incentive to own stocks is not great.

While it might be naïve to hope, perhaps the picture for domestic equities will become clearer as we navigate through 3rd quarter earnings announcements with the confidence that the newly required CEO/CFO certification of financial statements will provide a truer picture of where these companies really stand with respect to revenues, earnings and debt. If there's bad news to be reported, let's try to get it all out in 3Q 2002 when investor's expectations are already low.

While the near-term prospects for the equity markets are not bright, the fixed income markets, particularly the domestic and international government bond markets have done quite well. As a result of the incredible rally that has brought domestic interest rates to a 40-year low, *I am beginning to worry about the fixed income asset class, particularly longer-duration bonds.*

Here is the problem: the Federal Reserve has to keep *short-term interest rates low* to stimulate the economy, to keep liquidity in the financial system in times of crisis and potential crisis, and to defend against the possibility of domestic deflation (http://www.federalreserve.gov//Pubs/IFDP/2002/729/ifdp729.pdf). At the same time, *long-term interest rates may rise as the US Treasury will need to borrow* to pay for our efforts and presence in Afghanistan (and possibly Iraq), as well as our increased spending on homeland security and other necessary government programs. With tax revenue (capital gains tax, income tax, corporate taxes) significantly lower due to the depressed stock market, increased unemployment, and poor economy, the need for more government borrowing (US Treasury issuing bonds) could increase substantially in the near to intermediate-term.

As a consequence of this accommodative Federal Reserve keeping short interest rates low, and the significant borrowing needs of the US Treasury, *the US Treasury yield curve will steepen substantially.* This steepening will be driven by long-maturity US interest rates going up as the US Treasury issues more long-maturity debt. This steepening yield curve environment will have serious implications for asset allocation strategies, particularly with respect to the fixed income asset class. While short rates will stay low, long interest rates (10 years and longer) are vulnerable, and as a consequence, longer duration bonds are subject to significant price risk.

What I Am Thinking – Small Picture
Tax loss/gain harvesting season is upon us once again. Time for action.

It is probably fair to say that this year, even a well-diversified investment portfolio may have some losses, both realized and unrealized. While investment losses are always disappointing, it is important to maximize the usefulness of these losses in the context of managing a portfolio of investments.

Take gains for "free" when you can. To the degree you have unrealized gains in your portfolio, you may want to realize these gains to offset any realized capital losses you may have in other parts of your portfolio. By doing this, you can neutralize the capital gains taxes you would have had to pay on the position with the gain, effectively, taking the gain for "free" by harvesting/offsetting the gain against your loss. If you want to maintain a holding in the position with the gain, you can simply buy it back. There is nothing preventing you from buying the position with the gain back immediately, as the IRS's 30-day wash rule only applies to repurchases that relate to losses.

Tax harvesting can be extremely useful in the context of rebalancing a diversified investment portfolio. For example, this year, capital gains in the fixed income, TIPS, and REIT asset classes can be realized and offset against capital losses in the equity asset classes. The proceeds of these sales can be reallocated in the context of an investor's asset allocation plan, allowing for portfolio rebalancing while minimizing capital gains taxes.

With mutual fund year-end approaching on October 31, 2002 for the majority of mutual funds, it is likely that fund managers are selling any and all positions with gains to offset realized losers from earlier in the year. Unfortunately, for tax purposes, mutual funds cannot distribute realized losses, only realized gains. To capture funds with losses for tax-loss harvesting purposes, a mutual fund investor has to sell the fund. Tax gain/loss harvesting is an important, but often overlooked aspect of managing of taxable investment portfolios.

Marketing Works II

"It is easier for active managers of small cap stocks to beat passive small cap indices than it is for large cap managers to beat the passive large cap indices because small cap stocks are not as well covered by Wall Street analysts and as a result the small cap market is less efficient, and therefore the small cap indices are easier to beat"

Cocktail party conversation, everywhere in America

It is amazing how many people believe this stuff. Inappropriate performance measurement benchmark comparisons can really give investors the wrong idea about an investment and investment manager performance. As it pertains to the domestic small cap equity asset class, it appears that *marketing does work*, given the investment management industry has adopted the Russell 2000 index as the benchmark for domestic small cap stocks eventhough it is not a good or fair performance measurement benchmark for the domestic small cap stocks.

Many investment managers and mutual fund marketing companies compare their domestic small cap funds to the Russell 2000 with consistently favorable results. The reason this commonly used index is not a good measure of domestic small cap stock performance because it doesn't include the most important segment of domestic small cap stock universe: *the smallest stocks*.

In general, small cap stocks are riskier than larger cap stocks and as a consequence, small cap stocks should have a higher expected return than larger stocks over the long run.

The Russell 2000

The Russell 2000 small cap index is comprised of all the stocks in the Russell 3000 index (the 3,000 largest U.S. companies based on total market capitalization) minus the Russell 1000 (the 1,000 largest U.S. companies based on total market capitalization). These remaining 2,000 stocks comprise the Russell 2000 index and this index is widely considered to be the performance benchmark for the domestic small cap universe.

Using the Russell 2000 as a performance benchmark for domestic small cap stocks is extremely misleading. As the entire US stock market has over 5,000 stocks, the Russell 2000 index omits approximately 2,000 small cap companies. These are the smallest stocks in the domestic small cap universe, and as smaller stocks are more risky by virtue of their size, they also have the potential for the highest expected return.

If smaller stocks should have greater expected returns than larger stocks because they are riskier, it would stand to reason that the smallest, most risky stocks have the highest expected return over the long run. *As the Russell 2000 does not include these smallest stocks, is beating the Russell 2000 a big deal?*

CRSP

The Center for Research in Security Prices (CRSP) at the University of Chicago's Graduate School of Business was established in 1960. The CRSP database of securities prices is the most widespread and exacting of databases. Although CRSP is a household word among academic researchers, it is less well known to retail investors and the general public.

Like the Russell databases, CRSP includes securities prices for the entire universe of U.S. stocks, and divides those securities into sets of indexes. CRSP first sorts all stocks on the NYSE by market cap and breaks the universe into ten equal groups by number of names. These are called "deciles". Decile 1 is the group of the largest stocks on the NYSE and decile 10 is the group of the smallest socks on the NYSE. All AMEX and NASDAQ stocks are then merged into the NYSE size decile where they fit based on their market caps. *Deciles 6-10 are the broad database of small cap stocks* and deciles 1-5 are the broad database of large cap stocks. All CRSP indexes are rebalanced quarterly ensuring that the indexes best reflect the current marketplace. *The CRSP 6-10 represents the 4,000 smallest domestic stocks and is a passive, unmanaged index.*

How do the performance of Russell 2000 and the CRSP 6-10 indices compare over time?

Exhibit 1 -Historical Performance of the Russell 2000 vs the CRSP 6-10

As of 9/30/02	YTD	1YR	3YR	5YR	10YR	15YR	20YR	SD*
Russell 2000	-25.10%	- 9.30%	- 4.11%	- 3.19%	+ 8.01%	+6.84%	+10.43%	19.56
CRSP 6-10	-26.24%	- 5.33%	- 1.87%	- 1.01%	+10.18%	+8.40	+11.75%	20.10

*Standard Deviation calculated using monthly data

Many active domestic small cap managers claim to add value to the investment management process because they have outperformed the Russell 2000 on a regular basis. As we can see, the CRSP 6-10, as an unmanaged passive index of the 4,000 smallest stocks, has consistently outperformed the highly-publicized and heavily-marketed Russell 2000 on an annualized basis with marginally greater risk for over 20 years.

Why don't investment managers and mutual fund companies use a more appropriate index than the Russell 2000 to demonstrate the investment performance of their domestic small cap products? Perhaps it is because it is easier to build a stronger marketing campaign for active small cap management when the Russell 2000 is used. And because marketing works too.

The Lam Group:
In this uncertain market environment, it is important to pick the "low-hanging fruit" while it is within reach. This simple advice can apply to assets outside your investment portfolio: refinance your mortgage if you have one. Low long rates will not be here forever.

In this low interest rate environment, new and existing allocations to the fixed income asset class must be taken with great care as the risks in certain sectors of the fixed income market are now extremely high. As discussed earlier, the price sensitivity of longer duration bonds is much higher to changes in interest rates than shorter duration bonds. It is our current feeling that the US Treasury yield curve will steepen in the near future. A steep, positively sloped, yield curve has major implications for inflation, and the broad outlook for stocks, bonds, currencies and the real estate markets. As always, be mindful of your investment policy plan and rebalance towards your target asset allocation with discipline.

We have introduced a Frequently Asked Questions (FAQs) section in the Investment Topics section of our website (www.thelamgroup.com) to address basic questions prospective clients may have about our Firm. We expect to add a more advanced Frequently Asked Questions (FAQs II) section some time after Halloween.

Nelson J. Lam
The Lam Group, Inc.

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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 "value-added" approach includes the design of a client-specific asset allocation plan, the research and selection of the most cost efficient and appropriate asset class investments for a client's specific investment policy, and the monitoring and annual rebalancing of the 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 our client's portfolios.

	3Q 2002	YTD	Last 12 mos	Correlation* w/ S&P 500
Domestic Total Equity Market				
-Wilshire 5000 (Total Dom. Eq. Market)	-16.81%	-26.60 %	-17.52%	+ *0.970*
US Total Market Fund	-16.84%	-26.69%	-17.66%	+ *0.970*
Domestic Large Cap Stocks				
-S&P 500	-17.27%	-28.15%	-20.47%	+ *1.000*
Domestic Large Cap Value Fund	-19.72%	-19.88%	-10.35%	+ *0.751*
Domestic Small Cap Stocks				
-CRSP 6 -10	-21.00%	-26.24%	- 5.33%	+ *0.668*
-Russell 2000	-21.39%	-25.09%	- 9.30%	+ *0.625*
Domestic Small Cap Fund	-20.79%	-24.30%	- 7.15%	+ *0.639*
Domestic Small Cap Value Fund	-22.73%	-14.67%	+ 2.32%	+ *0.626*
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	- 9.08%	+ 3.08%	+ 8.13%	+ *0.230*
REIT Fund	- 8.24%	+ 3.66%	+ 8.22%	+ *0.219*
Domestic Bonds				
-Lehman Aggregate Bond Index	+ 4.59%	+ 8.56%	+ 8.60%	- *0.290*
US TIPS Fund	+ 7.71%	+16.00%	+14.54%	- *0.220*
Intermediate Domestic Bond Fund	+ 3.43%	+ 7.57%	+ 7.81%	- *0.240*
Short Duration Global Fund	+ 1.95%	+ 4.23%	+ 5.08%	- *0.410*
International (non-$) Bonds				
-Salomon Non-$ World Govt	+ 2.84%	+15.02%	+10.45	- *0.070*
Non-$ Bond Fund	+ 2.97%	+14.87%	+10.67%	- *0.110*
International Large Cap Stocks				
-MSCI EAFE (in US $, price only)	-19.67%	-20.78%	-15.25%	+ *0.825*
International Large Value Fund	-21.00%	-13.87%	- 9.83%	+ *0.696*
International Small Cap Stocks				
-MSCI Small Cap EAFE (in US $, px only)	-16.41%	- 9.06%	- 3.52%	+ *0.616*
International Small Cap Fund	-12.77%	- 0.13%	+ 1.93%	+ *0.547*
International Small Cap Value Fund	-11.78%	+ 3.25%	+ 5.12%	+ *0.498*

* 3 yr correlation using monthly data

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