

# The Lam Group

Investment Management

## The Lam Group Newsletter Vol. 2, No. 4 Fourth Quarter 2002

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### **The Big Picture – There is more than one market.**

2002 was a bad year for some investors. For investors that only owned domestic stocks in 2002 (or in new millennium for that matter), the risks inherent in pursuing a single asset class investment strategy have outweighed the rewards.

At the same time, 2002 was a good year for markets other than the stock market. The bond markets (all fixed income products except high yield) performed well in 2002 and inflation-related investments like Treasury Inflation Protected Securities (TIPS) and commodities had a fantastic year. The Real Estate Investment Trust (REIT) market had its third positive year in a row and foreign currencies have rallied strongly vs. the US dollar.

The point is: there are more markets than just the domestic stock market, and it has never been more important NOT to put all your eggs in one basket. One asset class portfolios are just too risky.

True portfolio diversification through developing a sound asset class allocation strategy is the most important decision many investors fail to make. An appreciation of realistic asset class returns and their relative historical correlations are critical to the development of an investment portfolio that maximizes return while minimizing risk.

Widely-accepted academic studies<sup>1</sup> have shown that for long-term investors, asset class selection in the context of disciplined asset allocation is the most important determinate of portfolio performance. The contribution to investment portfolio performance can be broken down as follows:

|                       |     |
|-----------------------|-----|
| Asset class selection | 94% |
| Security selection    | 4%  |
| Market timing         | 2%  |

It is unfortunate that many investors still only avail themselves to the “six percent solution”.

2003 will be a very interesting year for all the markets. The winning and losing asset classes of 2002 are unlikely to be the same as those in 2003. From a portfolio perspective, it is important to know which asset classes you own, and which you don't own, and why.

<sup>1</sup> Brinson, Hood and Beebower, "Determinants of Portfolio Performance," Financial Analyst Journal. July/August 1986

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### Investment Concept: Small is Beautiful

Most investors do not have a big enough allocation to small cap stocks.

As we have discussed in previous newsletters, small cap stocks are riskier (in general) than large cap stocks and as a consequence, small cap stocks should have a higher expected return than larger stocks over the long run.

As we can see from the historical data on Table 1, this has indeed been the case. Over the long run, the CRSP 6-10 small cap index, which encompasses the smallest 4,000 domestic stocks, have had a higher annualized return (and corresponding greater volatility) than an index of domestic large cap stocks. This is not surprising: higher risk, higher return.

**Table 1 – Comparison of Domestic Large Cap vs. Small Cap Equity Performance**

| <u>As of 12/31/02</u> | <u>YTD</u> | <u>3YR</u> | <u>5 YR</u> | <u>10YR</u> | <u>25YR</u> | <u>30YR</u> | <u>SD*</u> |
|-----------------------|------------|------------|-------------|-------------|-------------|-------------|------------|
| Large Cap (S&P 500)   | -22.10%    | -14.54%    | -0.57%      | +9.34%      | +12.98%     | +10.66%     | 15.97      |
| Small Cap (CRSP 6-10) | -19.65%    | -5.66%     | 1.74%       | +9.50%      | +13.60%     | +12.33%     | 21.83      |

\*Standard Deviation is a measurement of risk and is calculated for the 30 year period using monthly data

If we look at the historical data for the same period in Table 2, it is interesting to note is the similarity of the returns and risk measurements for the S&P 500 (500 domestic large cap stocks) and the CRSP 1-10 (all 5,000 domestic stocks). The CRSP 1-10 is a domestic all-cap equity index similar to the Wilshire 5000 (the CRSP data is used because 30 year data is not available from Wilshire).

**Table 2 - Comparison of Domestic Large Cap vs. All Cap Equity Performance**

| <u>As of 12/31/02</u> | <u>YTD</u> | <u>3YR</u> | <u>5 YR</u> | <u>10YR</u> | <u>25YR</u> | <u>30YR</u> | <u>SD*</u> |
|-----------------------|------------|------------|-------------|-------------|-------------|-------------|------------|
| Large Cap (S&P 500)   | -22.10%    | -14.54%    | -0.57%      | +9.34%      | +12.98%     | +10.66%     | 15.97      |
| All Cap (CRSP 1-10)   | -21.14%    | -14.67%    | -0.62%      | +8.91%      | +12.77%     | +10.55%     | 16.42      |

\*Standard Deviation is a measurement of risk and is calculated for the 30 year period using monthly data

As the CRSP 1-10 includes the 4,000 small cap stocks tracked by the CRSP 6-10, why are the CRSP 1-10 return and risk numbers so similar to those of the S&P 500's?

The answer is in the capitalization of the indices and the importance of size.

Indices such as the S&P 500, Wilshire 5000 and the CRSP benchmarks are capitalization weighted. This means that large companies have a larger contribution/weighting to a specific index than smaller companies.

The capitalization of the S&P 500 represents ~85% of the capitalization of the CRSP 1-10, leaving the representation of the small cap CRSP 6-10 at ~ 15% of the CRSP 1-10 all-cap market index.

As the historical return and risk profiles of the S&P500 and the CRSP 1-10 are very similar, *the higher return and risk characteristics of domestic small cap stock segment (~15%) of the Wilshire 5000 does not appear to have a meaningful effect from a performance perspective* compared to the

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performance of the S&P 500 alone. It appears that *having too little small cap exposure is almost like having none at all.*

For investors who can assume more risk and/or have a longer investment horizon, a domestic small cap stock allocation greater than 15% in the context of an overall domestic stock allocation may be helpful in increasing the potential expected return of a portfolio.

In addition to its higher risk and return characteristics relative to large cap stocks, the small cap stock asset class also has favorable historical correlation characteristics that can decrease portfolio risk from a diversification perspective.

**Table 3 – Relative Correlation\* for Large Cap, All Cap and Small Cap Equity Asset Classes**

| <u>As of 12/31/02</u> | <u>Large Cap (S&amp;P 500)</u> | <u>All Cap (CRSP 1-10)</u> | <u>Small Cap (CRSP 6-10)</u> |
|-----------------------|--------------------------------|----------------------------|------------------------------|
| Large Cap (S&P 500)   | +1.00                          |                            |                              |
| All Cap (CRSP 1-10)   | +0.99                          | +1.00                      |                              |
| Small Cap (CRSP 6-10) | +0.79                          | +0.86                      | +1.00                        |

\*30 year data

### **The Lam Group 2003 Investment Outlook:**

Our investment outlook for 2003 includes the following predictions, strategies, ideas and bias:

#### General:

- Inflation will become a problem before the 2004 Presidential election.
- The dollar will continue to weaken against foreign currencies of developed countries.
- Potential war and terrorism will be less relevant market factors than corporate malfeasance and US fiscal policy.

#### Bonds:

- The US Treasury yield curve will steepen and be driven by long interest rates rising.
- As inflation will become a more important consideration in 2003-04, *bonds are vulnerable.*
- There will be further opportunities to make tactical allocations to high yield, and credit-related fixed income products
- Favored fixed income sectors include:
  - short-duration bonds , non-\$ bonds , structured mortgages, TIPS and inflation-linked products
- Fixed income sectors to avoid include:
  - long-duration bonds of any type

#### Stocks:

- As we believe the dollar will weaken against developed market currencies, it is possible that international stocks will outperform domestic stocks.
- Large cap domestic stocks will continue to be negatively affected by corporate governance, underfunded pension liabilities and financial accounting issues.

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- Large cap growth-oriented stocks continue to be very speculative.
- Small cap stocks will outperform large cap stocks in the long run.
- REIT valuations will be come more reasonable

The Lam Group currently has over \$18 million in assets under management, with clients in Oregon, Washington State, California, New York and New Jersey. Portfolios managed for our clients include those for taxable investors, a family office, and a private tax-exempt foundation.

We are accepting a limited number of new clients in 2003. For those readers who would like to know us better, we have introduced a basic and advanced Frequently Asked Questions (FAQs) (FAQsII) section in the Investment Topics section of our website ([www.thelamgroup.com](http://www.thelamgroup.com)) to address questions prospective clients may have about our Firm.

Nelson J. Lam  
The Lam Group, Inc.  
January 22, 2003

Archives for The Lam Group Newsletter are available at our website: [www.thelamgroup.com](http://www.thelamgroup.com)

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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 "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.

| <u>Asset Class Category</u>                  | <u>4Q2002</u> | <u>YTD</u> | <u>3 Year Annualized</u> | <u>Correlation w/ S&amp;P 500</u> |
|--|---------------|------------|--------------------------|-----------------------------------|
| <u>Domestic Total Equity Market</u>          |               |            |                          |                                   |
| -Wilshire 5000 (Total Dom. Eq. Market)       | + 7.83%       | - 20.85%   | - 14.36%                 | + 0.97                            |
| US Total Market Fund                         | + 7.82%       | - 20.96%   | - 14.31%                 | + 0.97                            |
| <u>Domestic Large Cap Stocks</u>             |               |            |                          |                                   |
| -S&P 500                                     | + 8.42%       | - 22.09%   | - 14.55%                 | + 1.00                            |
| Domestic Large Cap Value Fund                | + 6.20%       | - 14.92%   | - 0.88%                  | + 0.78                            |
| <u>Domestic Small Cap Stocks</u>             |               |            |                          |                                   |
| -CRSP 6 -10                                  | + 8.93%       | - 19.65%   | - 5.66%                  | + 0.70                            |
| -Russell 2000                                | + 6.15%       | - 20.48%   | - 7.54%                  | + 0.63                            |
| Domestic Small Cap Fund                      | + 6.82%       | - 19.14%   | - 2.27%                  | + 0.66                            |
| Domestic Small Cap Value Fund                | + 6.33%       | - 9.27%    | + 6.55%                  | + 0.66                            |
| <u>Real Estate Investment Trusts (REITs)</u> |               |            |                          |                                   |
| -Wilshire REIT Index                         | + 0.49%       | + 3.60%    | + 15.11%                 | + 0.18                            |
| REIT Fund                                    | + 0.51%       | + 4.18%    | + 14.82%                 | + 0.17                            |
| <u>Domestic Bonds</u>                        |               |            |                          |                                   |
| -Lehman Aggregate Bond Index                 | + 1.57%       | + 10.27%   | + 10.10%                 | - 0.33                            |
| US TIPS Fund                                 | + 0.92%       | + 17.06%   | + 13.03%                 | - 0.32                            |
| Intermediate Domestic Bond Fund              | + 2.45%       | + 10.20%   | + 10.59%                 | - 0.24                            |
| Short Duration Global Fund                   | + 1.02%       | + 5.30%    | + 5.95%                  | - 0.45                            |
| <u>International (non-\$) Bonds</u>          |               |            |                          |                                   |
| -Salomon Non-\$ World Govt                   | + 6.06%       | + 21.99%   | + 4.64%                  | - 0.10                            |
| Non-\$ Bond Fund                             | + 5.79%       | + 21.81%   | + 4.93%                  | - 0.15                            |
| <u>International Large Cap Stocks</u>        |               |            |                          |                                   |
| -MSCI EAFE (in US \$, price only)            | + 6.45%       | - 15.94%   | - 17.24%                 | + 0.84                            |
| International Large Value Fund               | + 6.22%       | - 8.52%    | - 8.19%                  | + 0.72                            |
| <u>International Small Cap Stocks</u>        |               |            |                          |                                   |
| -MSCI Small Cap EAFE (in US \$, px only)     | - 0.58%       | - 9.58%    | - 11.07%                 | + 0.48                            |
| International Small Cap Fund                 | + 2.05%       | + 1.91%    | - 4.81%                  | + 0.53                            |
| International Small Cap Value Fund           | + 2.47%       | + 5.79%    | - 0.73%                  | + 0.50                            |

\* 3 yr correlation using monthly data

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