The Lam Group
Investment Management

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The Big Picture – Which Market is Right?
That was quite a quarter. All the equity and fixed income markets around the world ended in positive territory for 2Q 2003, and in most cases are up YTD. While rising markets are always welcome, the current level of euphoria in the equity markets, particularly in the domestic large-cap growth equity asset class, is difficult to explain given the continued weak economic data we are experiencing and the lack of real top-line revenue growth in corporate earnings.

Obviously, the power of massive central bank-provided liquidity before, during, and after the war in Iraq continues to be a significant market driver, at least in the near term. Financial assets almost always rise when cheap, fast money is available. However, with rates this low, the Fed does not have many market-levitating tricks left if the economy does not respond soon.

It is worth noting that the current high levels of the stock and bond markets offer investor's two entirely different interpretations of the outlook for the economy. The second quarter's breathtaking rally in stocks globally indicates that investors believe revenue growth and economic recovery are just around the corner. At the same time, the historical lows in interest rates and our central bank's concern of deflation indicate that the global economies are not well. While both the stock and the bond markets are up meaningfully this year, it is unfortunate that both markets cannot be right in their interpretation of the outlook for the economy.

If the bond market is right, the near term outlook for stocks, particularly high P/E sectors like domestic large-cap growth stocks, look quite risky at these levels. If the stock market is right, the bond market has some significant downside, especially in the traditional, longer-duration fixed income sectors.

Historically, the bond market has been a more accurate predictor for the outlook of the economy. While the stock and bond markets have both rallied, it is ironic that the Federal Reserve has been quietly worrying about deflation.

The discussion of inflation vs. deflation is an interesting one. In a broad sense, deflation occurs in the presence of falling asset prices and inflation occurs when asset prices go up. As the Fed is concerned that the current economic malaise will further deteriorate into deflation*, their policy actions suggest that the only way to defeat deflation is to create inflation*.

In a sense, we are in the midst of a period of *government-sponsored inflation.* With the Federal Reserve continuing its accommodative monetary policies, and the U.S. Treasury charged with funding an enormous budget deficit that is growing as a result of the recent tax cuts, war

expenditures, and other pre-election year fiscal policies, it is possible that the resulting liquidity in the financial system may ignite inflation in our efforts to defeat deflation.

Additionally, with the Fed keeping short rates low and the increased deficit spending putting upward pressure on long rates, the US Treasury yield curve is steep and getting steeper. Economic and capital markets theory tells us that a steeply sloped yield curve implies that inflation is ahead.

While no one seems to be worried about inflation at the present time, it is always surprising that many people think that an economic system can only experience inflation in the context of robust economic growth, where rising incomes and the increased competition for goods and services causes prices to rise. "*Too much money chasing too few goods*" is how many Economics 101 textbooks have defined inflation. With a robust economy, we welcome this "good" kind of inflation as prices go up because increased household incomes creates higher domestic demand.

There is, however, a "bad" kind of inflation that can be as problematic as the bad kind of cholesterol. The bad kind of inflation occurs when the purchasing power of our currency decreases relative to other currencies and, as a consequence, the relative price of goods and services goes up. With our aggressive monetary policy and large budget deficit (recently estimated by the White House to be $455 billion) the US $ has weakened considerably vs. currencies of other developed nations (over the last 18 months, the US $ has weakened 22.6% vs. the Euro). *The loss in purchasing power has the same effect as rising prices.* This is the bad kind of inflation, especially during a period of high unemployment, low capacity utilization, and weak economic growth.

The scope of this issue is global in nature and therefore having an investment portfolio with non-$ exposures in both bonds and stocks has never been more important. As illustrated in the Asset Class Investment Results section below, the international equity and fixed income asset classes outperformed their domestic counterparts in the most recent quarter, and in most cases YTD.

Investment Concept: Tax Harvesting – Be Prepared
Historically, October is a volatile month for the stock market.

Anyone who discusses the stock market's increased volatility in the month of October and doesn't mention the fact that October 31st is mutual fund year-end for tax purposes isn't participating in the market with full information. This is important information to have.

The mutual fund industry sets October 31st as their year-end for tax reporting purposes to allow sufficient operational time to process tax gain/loss information and income and capital distributions in time for the calendar year-end. Most mutual fund investors operate on a calendar year basis for tax purposes and usually receive their 1099 forms at calendar year end.

It is worth noting that mutual funds can only distribute realized capital gains to investors, they cannot distribute realized losses. When a fund has realized capital losses, these losses are first used to offset realized capital gains (to the extent there are any), and any remaining capital loss is carried forward to offset potential realized capital gains in future years.

With the losses many equity mutual funds experienced over the last three years, there are many funds that have substantial imbedded capital losses. This is particularly true for younger mutual funds that were introduced near the market peak in 1999-2000. Owning a fund with imbedded capital losses can actually a good thing, especially if the market is poised to rise. If the market goes up and the mutual fund realizes capital gains on new positions, these gains can be offset against existing imbedded losses in the fund, in effect neutralizing the capital gains tax the mutual fund investor has to pay on these new gains.

With the recent surge in the stock market, it is likely many mutual funds, and taxable investors in general, will have capital gains that can be realized to offset losses incurred in prior years. In certain cases, it may be possible to offset net short-term gains (taxed at income levels) against net long-term losses (taxed at capital gains rates), providing even greater incentive to sell recent winners. At the stock market's current levels, *this capacity to sell without incurring capital gains tax may give the market more downside vulnerability as tax harvesting season approaches.*

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While it is impossible to forecast whether the stock or the bond market is right on the economy, we continue to approach the markets and our portfolios with a disciplined and consistent asset allocation framework. At this time, while all asset classes seem high relative to the economic environment, it is important to remember that as investors, we cannot have an expectation of positive return without taking some level or risk.

For our fixed income allocations, with US interest rates at a 40+ year cyclical extreme, we feel the risks are quite high in the traditional investment grade sector (particularly in the long end of the yield curve) relative to the limited potential for capital appreciation. As a consequence, our fixed income exposures continue to be heavily concentrated in non-$ bonds and TIPS, reflecting our view on the relative strength of the US $, the likelihood of inflation, and potential steepening of the yield curve. Additionally, we maintain our diversified exposures in emerging markets debt, high-yield bonds and short-duration municipal and mortgage-related investment grade bonds.

For our equity allocations, we continue to be wary of the domestic large cap asset class, despite its recent run up. Top line revenue growth and options-adjusted P/E ratios are our biggest concerns in this sector. Our equity exposures continue to be the fullest in the small cap sector, both domestically and internationally as we feel that the expected return of smaller stocks, while riskier, should be higher than large cap stocks over time. It is worth noting the international small cap asset class has the additional benefit of the currency tailwind. We continue to like the REIT and emerging market equity asset classes and look forward to add to these sectors opportunistically.

Our investment outlook for the second half of 2003 remains consistent with our outlook at the beginning of 2003 (which we articulated in the 4Q2002 newsletter). We continue to feel that over the intermediate-to-longer term, the weak US $ and the factors that are causing the US Treasury yield curve to steepen are worthy of investor focus and that these issues are important considerations in evaluating the global risks in the equity and fixed income markets.

On an administrative note, we are pleased to announce the addition of Fidelity Institutional as a custodial alternative for clients of The Lam Group. Having the combination of Fidelity and Schwab's institutional custodial platforms will give our clients access to a broader range of investment products and help keep transactions and administrative costs for our clients low.

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) to address questions prospective clients may have about our Firm.

Nelson J. Lam
The Lam Group, Inc.
July 16, 2003

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.

Asset Class Category	2Q2003	YTD	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 (Total Dom. Eq. Market)	+16.51%	+12.92%	-10.57%	+ 0.99
US Total Market Fund	+16.46%	+12.80%	-10.58%	+ 0.99
Domestic Large Cap Stocks				
-S&P 500	+15.39%	+11.75%	-11.19%	+ 1.00
Domestic Large Cap Value Fund	+17.76%	+11.14%	+ 5.45%	+ 0.85
Domestic Small Cap Stocks				
-CRSP 6 -10	+28.89%	+23.64%	+ 0.16%	+ 0.85
-Russell 2000	+23.42%	+17.88%	- 3.30%	+ 0.84
Domestic Small Cap Fund	+25.72%	+19.53%	+ 1.33%	+ 0.85
Domestic Small Cap Value Fund	+28.03%	+18.28%	+10.75%	+ 0.76
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	+12.10%	+13.46%	+14.75%	+ 0.23
REIT Fund	+11.79%	+13.59%	+14.66%	+ 0.22
Domestic Bonds				
-Lehman Aggregate Bond Index	+ 2.50%	+ 3.92%	+10.08%	- 0.41
US TIPS Fund	+ 3.81%	+ 6.09%	+12.76%	- 0.35
Intermediate Domestic Bond Fund	+ 2.83%	+ 4.96%	+10.90%	- 0.32
Short Duration Global Fund	+ 0.82%	+ 1.50%	+ 5.56%	- 0.50
International (non-$) Bonds				
-Salomon Non-$ World Govt	+ 4.21%	+ 8.09%	+ 8.09%	- 0.19
Non-$ Bond Fund	+ 5.26%	+10.06%	+ 8.64%	- 0.10
International Large Cap Stocks				
-MSCI EAFE (in US $, price only)	+19.27%	+ 9.47%	-13.54%	+ 0.87
International Large Value Fund	+23.19%	+13.82%	- 4.38%	+ 0.74
International Small Cap Stocks				
-MSCI Small Cap EAFE (in US $, px only)	+23.99%	+19.57%	- 7.27%	+ 0.68
International Small Cap Fund	+23.59%	+23.36%	+ 0.83%	+ 0.60
International Small Cap Value Fund	+27.34%	+27.16%	+ 6.41%	+ 0.56

* 3 yr correlation using monthly data

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