The Lam Group
Investment Management

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The Big Picture: Be Prepared
In 2004, domestic large cap stocks, as measured by the S&P 500 Index, returned +10.87%, and domestic investment grade bonds, as measured by the Lehman Aggregate Bond Index, returned +4.34%. For the second time since the new millennium began, domestic stocks outperformed domestic bonds. As stocks are generally riskier than bonds, this is supposed to be the case.

While domestic large cap stocks are “2 for 5” versus domestic bonds in the new millennium, it is worth noting that the 2004 return for the S&P 500 is close to its long-term historical average return of 10.4%. Is everything getting back to “normal” in the world of investment returns?

Before we answer that question, let’s look at domestic large cap stocks in the context of other equity markets domestically and around the globe:

Equity Asset Class Category*	2004	3 Year Annualized	5 Year Annualized
Domestic Large Cap Stocks			
-S&P 500 Index	**+10.87%**	+ 3.58%	- 2.30%
Domestic Small Cap Stocks			
-Russell 2000 Index	**+18.33%**	+11.48%	+ 6.61%
Real Estate Investment Trusts (REITs)			
-Wilshire REIT Index	**+33.82%**	+23.56%	+22.67%
International Large Cap Stocks			
-MSCI EAFE Index	**+20.25%**	+11.89%	- 1.13%
International Small Cap Stocks			
-MSCI Small Cap EAFE Index (px only)	**+28.16%**	+22.28%	+ 7.30%
Emerging Markets Equity			
-MSCI Emerging Markets Free Index	**+22.45%**	+19.54%	+ 2.09%

* index data provided by Morningstar, PIMCO and MSCI.

In 2004, and for annualized periods over the past 3 and 5 years, domestic large cap stocks have significantly underperformed other major equity asset classes both domestically and abroad. While the outperformance of small cap stocks versus large cap stocks should be expected over the long run (small cap stocks are riskier and therefore should have a higher expected return), the underperformance of the domestic large cap asset class versus the rest of the world is noteworthy, especially when one considers that the S&P 500 represents a large share of our country’s (~80%) and the world’s (~50%) public equity capitalization.

To further complicate matters, let's consider the domestic large cap equity asset class versus several broad domestic and international fixed income asset classes:

Asset Class Comparison*	**2004**	**3 Year Annualized**	**5 Year Annualized**
Domestic Large Cap Stocks			
-S&P 500 Index	**+10.87%**	+ 3.58%	- 2.30%
Domestic Investment Grade Bonds			
-Lehman Aggregate Bond Index	**+ 4.34%**	+ 6.19%	+ 7.71%
Domestic High Yield Bonds			
-CSFB High Yield Bond Index	**+11.96%**	+13.88%	+ 8.17%
Inflation-Linked Bonds			
-Lehman TIPS Index	**+ 8.46%**	+11.07%	+10.84%
International (non-US $) Bonds			
-Citigroup Non-$ World Govt Index	**+12.14%**	+17.48%	+ 8.77%
Emerging Markets Debt			
-JP Morgan EMBI+ Index	**+11.62%**	+17.99%	+13.52%

* index data provided by Morningstar, PIMCO and MSCI.

In 2004, and annualized period for the past 3 and 5 years, domestic large cap stocks have underperformed the majority of the world's fixed income markets. This underperformance is particularly unsettling when one considers that the riskiness/volatility of these fixed income asset classes is generally lower than the riskiness/volatility of the domestic large cap equity asset class.

It is also worth noting that over these same periods in the domestic bond market, inflation-linked bonds (TIPS) have outperformed traditional domestic bonds.

What does all this mean?

Simply put, it means that it is impossible to predict investment returns. However, as Louis Pasteur said in 1854:

"Chance favors only the prepared mind."

With Dr. Pasteur's insight, the need for a properly balanced portfolio strategy that incorporates global asset class diversification has never been more meaningful for long-term investors. The composition and management of these exposures require an appreciation of the risk, return and the relative correlation characteristics of each asset class to ensure adequate diversification and the overall management of portfolio risk.

Market Perspective: The Price of Oil and the Value of the US Dollar
The global market convention for buying and selling oil is based on a system entirely denominated in US dollars. If the value of the US dollar declines, oil producers must raise their prices just to maintain profit margins.

As the value of the US dollar has dropped steadily over the past 5 years, the increase in the price of oil should be no surprise to investors who understand this negatively correlated relationship.

Oil and Currency Comparison*	**2004**	**3 Year Annualized**	**5 Year Annualized**
Crude Oil (CBOE)	+25.10%	+ 9.87%	+ 6.33%
US $ vs Euro	- 7.71%	-13.07%	- 5.79%
US $ vs Japanese Yen	- 4.65%	- 7.98%	+ 0.05%

* index data provided by Yahoo Finance.

The importance of having portfolio exposures to real assets (such as oil and other commodities) as well as non-$ assets may be as important in the next 5 years as it has been over the last 5 years.

2005 Investment Outlook

Our investment outlook for 2005 is not that much different than our outlook a year ago. Without the uncertainty of a Presidential election, the 2004 investment themes of a weaker US $, rising global inflation and the question of which country's central bank will raise US interest rates, will continue to be 2005's greatest investment challenges and drivers. As a consequence, having a meaningful portfolio allocation to non-US and real asset classes will be as important in 2005 as it was in 2004 (and 2003).

Here are our 2005 predictions, strategies, ideas and biases:

General:

- It is likely the US dollar will continue to weaken against the currencies of developed countries.
- Record debt/high leverage at the US government, corporate and personal level will limit the Fed's ability to meaningfully raise interest rates and defend the currency.
- Inflation, driven by the weaker US dollar, will result in even higher commodities prices.

Bonds:

- Domestic Fixed Income: Keep durations short and credit quality high for both investment grade and non-investment grade exposures.
- International Fixed Income: Maximize foreign currency exposure with non-$ developed-country bond allocations that leave the currencies unhedged. Maintain adequate emerging markets debt allocation as emerging markets countries have strengthening economies and improving trade surpluses with developed countries.
- Inflation-linked Fixed Income: Maximize commodities exposures and be prepared for volatility. Maintain adequate Treasury Inflation Protected Securities (TIPS) exposure.

Stocks:

- As it is our belief that the US dollar will continue to weaken against developed market currencies, it is possible that international stocks will continue to outperform domestic stocks, particularly in the small cap asset class as international small cap stocks have greater correlation to their local economies and currencies.

- The emerging markets equity asset class should continue to benefit from their lower labor costs and growing economies.
- The valuation of REIT and commercial real estate investments (real assets) will be less sensitive to the overall level of interest rates and more sensitive to the weakness of the US dollar and inflation. As commercial real estate can't be "printed" as quickly or readily as the US Treasury can "print" more debt, real assets may hold their value better than financial assets.

At this time, while all investment asset classes seem very high relative to the economic environment, it is important to remember that, as investors, we cannot have an expectation of positive return without assuming some level of risk. The investment risks we take for ourselves and our clients are purposeful, yet mitigated by the diversifying effects of combining various asset classes with low relative correlations in our global portfolios.

The Lam Group
With our asset allocation-based portfolio management approach, we try to minimize our reliance on luck, and as a consequence, take no credit for it. The Lam Group designs globally diversified portfolios that take into consideration a client's risk profile, time horizon, and tax position. Central to our investment strategy is tax-efficiency, achieved through tax gain/loss harvesting, and risk management using disciplined portfolio rebalancing. All portfolios are constructed with distinct asset classes that have low relative correlations and we employ asset class managers with the lowest cost structure (no hidden fees or expenses).

The Lam Group is an independent, fee-only, SEC-registered investment advisory firm with over $95 million in assets under management and clients in Oregon, Washington State, California, New York and New Jersey.

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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 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.

Equity Asset Class Category	4Q2004	2004	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	+10.33%	+12.62%	+ 5.47%	+0.99
US Total Market Fund	+10.33%	+12.56%	+ 5.36%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	+9.23%	+10.87%	+ 3.58%	+1.00
Domestic Large Cap Value Fund	+12.09%	+18.25%	+10.59%	+0.92
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	+15.17%	+19.42%	+14.96%	+0.85
-Russell 2000 Index	+14.09%	+18.33%	+11.48%	+0.83
Domestic Small Cap Value Fund	+15.08%	+23.39%	+21.95%	+0.76
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	+16.69%	+33.82%	+23.56%	+0.34
REIT Fund	+15.50%	+32.07%	+23.10%	+0.33
Real Estate Fund	+11.52%	+28.16%	+22.42%	+0.55
International Large Cap Stocks				
-MSCI EAFE Index	+15.32%	+20.25%	+11.89%	+0.89
International Large Cap Value Fund	+17.03%	+28.80%	+20.88%	+0.84
International Small Cap Stocks				
-MSCI Small Cap EAFE Index (in US $, px only)	+17.21%	+28.16%	+22.28%	+0.70
International Small Cap Value Fund	+18.09%	+34.80%	+33.40%	+0.62
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	+16.81%	+22.45%	+19.54%	+0.84
Emerging Markets Value Fund	+18.10%	+28.88%	+30.51%	+0.77

* 3 yr correlation using monthly data

Fixed Income Asset Class Category	4Q2004	2004	3 Year Annualized	Correlation w/ S&P 500*
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	+ 0.06%	+ 1.09%	+ 3.03%	-0.54
Short Duration Domestic Inv. Gr. Bond Fund	+ 0.05%	+ 0.73%	+ 2.62%	-0.33
Short Duration Domestic Muni Bond Fund	+ 0.43%	+ 1.40%	N/A	N/A
-Lehman Aggregate Bond Index	+ 0.95%	+ 4.34%	+ 6.19%	-0.34
Domestic Investment Grade Bond Fund	+ 1.38%	+ 5.15%	+ 6.94%	-0.24
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	+ 4.56%	+11.96%	+13.88%	+0.54
High Yield Bond Fund	+ 4.32%	+ 8.38%	+10.67%	+0.70
Inflation-Linked Bonds				
-Lehman TIPS Index	+ 2.51%	+ 8.46%	+11.07%	-0.31
TIPS Fund	+ 2.95%	+ 9.20%	+11.52%	-0.30
Commodities-Linked Fund	- 2.49%	+16.36%	N/A	N/A
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	+10.64%	+12.14%	+17.48%	-0.11
Non-$ Bond Fund	+10.28%	+11.67%	+18.03%	-0.06
Emerging Markets Debt				
-JP Morgan EMBI+ Index	+ 4.89%	+11.62%	+17.99%	+0.52
Emerging Markets Debt Fund	+ 5.78%	+12.24%	+18.85%	+0.52

* 3 yr correlation using monthly data