The Lam Group
Investment Management

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The Big Picture: Oil, Soil and Toil…
With oil over $60/barrel, valuations of real estate (commercial and residential) at record-breaking levels, and emerging countries consuming resources like new-born babies needing to be fed:

What is the world coming to?

In the first half of 2005, aggregate performance for investment portfolios without meaningful asset class exposures to some combination of commodities, REITs and emerging markets (debt and equity) was likely to be negative.

Asset Class	YTD 2005 (thru 6/30)
CBOE Oil Index (Commodities)	+22.40%
Wilshire REIT Index (RE)	+ 6.84%
MSCI Emerging Market Equity Index (EMS)	+ 4.24%
JPM Emerging Markets Debt Index (EMD)	+ 5.44%

To add insult to injury, while they were widely expected to rise in 2005 (as they were also supposed to in 2004), US interest rates fell, and performance of domestic investment-grade bonds trounced domestic stocks (both large and small) and international large-cap stocks in the first half of 2005.

Asset Class	YTD 2005 (thru 6/30)
Lehman Brother Aggregate Bond Index (DFI)	+ 2.51%
Lehman TIPS Index (TIPS)	+ 2.71%
S&P 500 Index (DLC)	- 0.81%
Nasdaq Composite (DLC)	- 5.45%
Russell 2000 Index (DSC)	- 1.25%
MSCI EAFE Index (ILC)	- 1.17%

Despite the continued growth of our domestic budget and international trade deficits and the looming prospect of a revaluation of China's currency, the widely anticipated continued weakening of the US dollar has not yet materialized in 2005. In fact, for the first half of 2005, the US dollar strengthened 11.9% vs the Euro and 8.0% vs the Yen.

To add to the global confusion, the asset classes with the highest sensitivity to currency fluctuations (international small cap equity and non-$ bonds with unhedged currencies) exhibited some rather schizophrenic behavior in the first half of 2005:

Asset Class	YTD 2005 (thru 6/30)
MSCI EAFE Small Cap Index (ISC)	+ 3.28%
Citigroup Non-$ Bond Index (IFI)	- 5.71%

Once again, what the markets are telling us is that investment returns are difficult to predict and that over the long run, market timing of either individual securities or market sectors can be a less fruitful endeavor when compared to a disciplined portfolio asset allocation approach with a balanced and global perspective.

That being said, the most vexing issue in today's market continues to be the "conundrum" of low long-term US interest rates and the unexpected rally in the value of the US dollar. This low interest rate/strong dollar configuration is particularly confusing with the prospect of a revaluation of China's currency combined with the possibility that China may be changing its approach to how it invests/redeploys its surplus balances of US dollars.

Global Insight: China's New Role

As we all know by now, China exports more than it imports, and its current account balance with the US is growing. Because the value of the Chinese yuan is pegged to the US dollar, China's central bank must constantly buy US dollars to maintain an 8.3 Yuan/Dollar relationship. This means that China buys billions of US dollars annually, and uses the proceeds to invest in US Treasury notes and bonds. At this time, China is one of the largest buyers/owners of US debt in the world. This is one of the reasons our interest rates have stayed low even though the absolute level of US Treasury borrowing has skyrocketed.

What if China's interest in our currency or our debt were to change?

If the Chinese yuan-US dollar peg were to be relaxed or severed, any free market movement would likely result in the yuan strengthening at the expense of the dollar. Consequently, China would need to buy fewer US dollars than they have in the past which could cause the US dollar to fall. This could result in upward pressure on interest rates in the US as higher interest rates would be required to attract replacement buyers for the Chinese.

As China becomes a more developed economy, the question of yuan revaluation becomes one of when rather than if. In the meantime, it is likely that China has been thinking of other uses of their US dollars before they make any policy changes with respect to foreign exchange rates. With yields on US Treasury 10-year notes hovering around 4% and our budget and trade deficits continuing to grow unabated (eroding the value of dollar-denominated bond holdings), if you were a major global investor with US dollars to spend:

would you rather buy more US government debt, or something more useful?

On 6/23/05, the Chinese oil company, CNOOC Limited, announced an $18.5 billion acquisition offer for US oil company Unocal. This all-cash offer is expected to be financed by various government agencies (who have access to China's vast US dollar balances). While there are many regulatory and security issues to be addressed with respect to this specific transaction, with their surplus of US dollars, China's appetite for acquisitions (using government agency financing) of global companies and resources is likely to grow in the coming years irrespective of when they revalue their currency.

These initial deals, the ongoing CNOOC bid for Unocal (to directly address China's exploding demand for energy), or the already completed $1.75 billion acquisition of IBM's PC division by government-owned computer maker Lenovo (gaining global management and marketing expertise to complement their dominance in low-cost PC manufacturing), show a pragmatic and strategic approach to buying global franchises.

If China (and other countries with surplus US dollars) look beyond the US bond markets to invest/deploy these dollars, their appetite for, and the valuations of, companies, commodities, real estate and services can only increase in the future.

With China's acquisitive powers on the rise, this is likely to set the stage for meaningful inflationary pressures in the US. The recent increases in the prices of gasoline/oil, building materials/housing, and other commodities/real assets are early evidence of this.

Real assets, such as real estate (including REITs) and other inflation-linked investments (TIPS and commodities) can provide meaningful diversification and risk/return characteristics to an investment portfolio, particularly in inflationary or weakening US dollar environments.

The importance of having exposures to real assets will be increasingly important to preserve the long-term purchasing power of a global investment portfolio.

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While the investment results for the majority of asset classes in the first half of 2005 appear lackluster, the six month numbers do not illustrate the higher volatility within each asset class over this period. With short-term interest rates rising and the yield curve flattening, the period of "free money" enjoyed by leveraged investment vehicles such as hedge funds and other speculators is coming to an end.

As the tide of "free money" goes out, it will be illuminating to see which investors still have their bathing suits on…and which ones get caught with their pants down. It is not likely to be pretty…

With the potential for slower growth globally and fewer investment opportunities, there is the possibility that we may be entering a period of lower returns than have been enjoyed during the 2003-2004 period. While investment returns are impossible to predict, in a lower-return environment, a disciplined portfolio focus on intelligent asset class diversification, expense minimization and tax efficiency become increasingly important to aggregate portfolio performance.

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The Lam Group is an independent, fee-only, SEC-registered investment advisory firm with over $125 million in assets under management and clients in Oregon, Washington State, California, Connecticut, New York and New Jersey. We offer both investment management and portfolio consulting services for taxable investors, family offices, foundations, and endowments.

Our asset allocation approach utilizes a highly analytical process to determine the appropriate combination of asset classes to build investment portfolios and strategies that realistically and optimally reflect the needs, risk tolerances, and investment horizons of our clients.

The Lam Group is now accepting new clients on a referral basis only.

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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	**2Q2005**	**12 Mo.**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	+ 2.47%	+ 8.38%	+ 9.97%	+0.99
US Total Market Fund	+ 2.20%	+ 8.08%	+ 9.80%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	+ 1.37%	+ 6.32%	+ 8.28%	+1.00
Domestic Large Cap Value Fund	+ 2.75%	+15.05%	+11.73%	+0.95
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	+ 3.94%	+10.10%	+17.05%	+0.87
-Russell 2000 Index	+ 4.32%	+ 9.45%	+12.81%	+0.85
Domestic Small Cap Value Fund	+ 3.02%	+12.64%	+18.00%	+0.83
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	+15.14%	+34.90%	+21.13%	+0.36
REIT Fund	+14.71%	+33.22%	+20.81%	+0.35
Real Estate Fund	+ 8.43%	+30.93%	+23.00%	+0.58
International Large Cap Stocks				
-MSCI EAFE Index	- 1.01%	+13.65%	+12.06%	+0.92
International Large Cap Value Fund	- 1.40%	+16.47%	+17.02%	+0.89
International Small Cap Stocks				
-MSCI Small Cap EAFE Index (in US $, px only)	- 0.49%	+18.58%	+20.18%	+0.72
International Small Cap Value Fund	- 1.14%	+24.88%	+28.84%	+0.65
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	+ 3.00%	+30.77%	+20.91%	+0.83
Emerging Markets Value Fund	+ 1.05%	+42.45%	+33.14%	+0.78

* 3 yr correlation using monthly data

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Fixed Income Asset Class Category	2Q2005	12 Mo.	3 Year Annualized	Correlation w/ S&P 500*
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	+ 1.20%	+ 2.07%	+ 2.47 %	-0.40
Short Duration Domestic Inv. Gr. Bond Fund	+ 1.19%	+ 2.77%	+ 3.46%	-0.16
Short Duration Domestic Muni Bond Fund	+ 1.13%	+ 2.53%	N/A	N/A
-Lehman Aggregate Bond Index	+ 3.01%	+ 6.80%	+ 5.76%	-0.26
Domestic Investment Grade Bond Fund	+ 3.21%	+ 7.70%	+ 6.57%	-0.15
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	+ 1.90%	+10.10%	+14.11%	+0.50
High Yield Bond Fund	+ 1.96%	+ 4.29%	+10.30%	+0.65
Inflation-Linked Bonds				
-Lehman TIPS Index	+ 3.05%	+ 9.34%	+ 9.42%	-0.26
TIPS Fund	+ 2.90%	+ 9.72%	+ 9.74%	-0.24
Commodities-Linked Fund	- 2.92%	+16.07%	+26.55%	-0.20
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	- 2.69%	+ 7.75%	+10.98%	+0.04
Non-$ Bond Fund	- 2.84%	+ 6.15%	+11.01%	+0.09
Emerging Markets Debt				
-JP Morgan EMBI+ Index	+ 6.48%	+20.20%	+19.65%	+0.52
Emerging Markets Debt Fund	+ 6.96%	+22.26%	+20.98%	+0.51

* 3 yr correlation using monthly data