<u>The Lam Group Newsletter Vol. 6, No. 1</u>
First Quarter 2006

- The Big Picture: The Certainty of Instability
- The Lam Group
- Asset Class Investment Results

The Big Picture: The Certainty of Instability

Having an investment portfolio managed with a globally-diversified asset allocation plan is a wise approach. However, without a disciplined portfolio rebalancing program, market forces will cause actual allocations to drift outside defined target ranges and expose the investor to more risk than they may have originally intended to take.

With the stellar performance of the domestic and international small cap and emerging market equity, real estate and commodities markets over the last three years, it is highly likely that many balanced and initially diversified portfolios are now riskier than before, especially if a disciplined (and often taxable) portfolio rebalancing has not been undertaken.

In our view, the only way to consistently *"buy low and sell high"* <u>without</u> trying to time the markets is to have a well-defined, multi-asset class portfolio allocation plan, and then rebalance the underlying asset classes when market forces "unbalance" the portfolio relative to the original plan.

The primary reason for periodic portfolio rebalancing is to manage the overall risks an investor is exposed to in a multi-asset class portfolio. To do this, an investor must appreciate that markets are unpredictable, and have a keen awareness and acceptance that the unexpected is possible. As a consequence, during periods of steadily rising, if not explosive market performance, discipline is necessary to distance the rebalancing process from the often emotional, momentum and tax-driven forces that can cloud the portfolio decision-making process. Often, professional discipline is necessary.

Periodic portfolio rebalancing assists the investor in taking the risks they intended to, and minimizes their capacity to take unintended risks.

With regard to unintended risks, the late economist Dr. Hyman Minsky once said:

"If you have a wonderfully stable world and... it is growing nicely and nothing is going wrong you are likely as the years go by to take more risk and more risk and more risk and the cost of taking it becomes less … and you can imagine that people will get carried away into thinking that such conditions are permanent and take on record levels of debt. They think conditions will always be safe, they will always be good. And then all it takes is some small event to create instability..."

If a historically risky asset class hasn't exhibited volatile behavior or poor performance for a period of time, could one reasonably conclude that this particular market is no longer risky?

Since early 2003, the investment performance of the domestic and international small cap and emerging markets equity, real estate, and commodities asset classes have been breathtaking.

As a consequence of the outperformance of these asset classes, many globally diversified portfolios have become underweighted in other asset classes such as large cap stocks (domestic and foreign), as well as domestic bonds and TIPS.

This is not to say that now is the time to buy domestic and international large cap stocks, domestic bonds or TIPS. Rather, the *allocation drift* within a given portfolio that is caused by outperformance of some asset classes relative others has made the aggregate portfolio more risky than originally intended. As risk management of an overall portfolio is as important as aggregate investment performance, the discipline of portfolio rebalancing is essential.

Table 1 illustrates the 3 yr, 5 yr and 10 yr annualized performance and risk measures (in terms of standard deviation) of the major traditional investment asset classes.

Table 1 – Recent Asset Class Annualized Return and Risk Data

Investment Asset Classes	Annualized Return in % as of 3/31/06			Standard Deviation* as of 3/31/06		
Equities	**3yr**	**5yr**	**10yr**	**3yr**	**5yr**	**10yr**
S&P 500 Index (Domestic Large Cap)	17.21	3.97	8.95	8.78	13.98	15.62
Nasdaq Composite Index (Dom. Large Cap Growth)	20.38	4.92	7.83	14.57	23.34	29.03
Russell 2000 Index (Domestic Small Cap)	29.53	12.59	10.15	15.44	18.99	20.36
Wilshire REIT Index (REITs)	33.18	22.97	16.76	15.81	14.74	14.39
MSCI EAFE Index (International Large Cap)	31.13	9.64	6.49	10.77	14.83	15.02
MSCI EAFE Small Cap Index (Int'l Small Cap)	41.96	18.18	5.51	12.68	15.80	16.20
MSCI EMF Index (Emerging Markets)	42.50	20.28	4.99	16.63	19.70	24.02
Fixed Income	**3yr**	**5yr**	**10yr**	**3yr**	**5yr**	**10yr**
Lehman Aggregate Bond (Dom. Investment Grade)	2.92	5.11	6.29	4.14	4.02	3.65
CSFB High Yield Bond Index (Non-Invest.Grade)	12.20	9.43	7.23	4.79	6.54	6.46
Citigroup Non-$ Bond Index (International Bonds)	5.10	8.31	4.57	8.48	8.34	8.20
JP Morgan Emerging Markets Debt Index (EM Debt)	14.53	12.42	13.22	7.90	10.36	15.11
Lehman TIPS Index (TIPS)	4.75	7.24	N/A	6.54	6.36	N/A
DJ AIG Commodities Index (Commodities)	15.90	11.77	7.93	13.47	13.81	14.06

Data provided by Morningstar, DFA and PIMCO

It is worth noting that while the 3 yr annualized returns for most equity market asset classes are impressive, the 5yr, and more notably, the 10yr annualized returns are significantly *lower*. At the same time, the risk measures for the same asset classes are higher for the 10yr annualized period than for the 3 yr annualized period reflecting the higher volatility (greater risk) over this longer period.

* standard deviation is a measurement of risk/volatility: the higher the value, the higher the risk/volatility

Tables 2a and 2b are illustrative of market "instability" in the equity, fixed income, real estate and commodities markets over the last 20 years no doubt created by unexpected "small events" that Dr. Minsky spoke of.

Table 2a – The Bad Years – Equities (including REITS)

Investment Asset Classes	3 Worst Calendar Years Since 1985		
S&P 500 Index (Domestic Large Cap)	-22.1% in 02	-11.9% in 01	- 9.1% in 00
Nasdaq Composite Index (Dom. Large Cap Growth)	-31.4% in 02	-20.8% in 01	-39.2% in 00
Russell 2000 Index (Domestic Small Cap)	-20.5% in 02	-19.5% in 90	- 8.8% in 87
Wilshire REIT Index (REITs)	-17.0% in 98	-23.4% in 90	- 6.6% in 87
MSCI EAFE Index (International Large Cap)	-15.9% in 02	-21.4% in 01	-23.4% in 90
MSCI EAFE Small Cap Index (Int'l Small Cap)	- 9.6% in 02	-14.3% in 01	-24.6% in 97
MSCI EMF Index (Emerging Markets)	-30.0% in 00	-25.3% in 98	-10.6% in 90

Data provided by Morningstar, DFA and PIMCO

Table 2b – The Bad Years – Fixed Income and Commodities

Investment Asset Classes	3 Worst Calendar Years Since 1985		
Lehman Aggregate Bond (Dom. Investment Grade)	+ 2.4% in 05	- 0.8% in 99	- 2.9% in 94
CSFB High Yield Bond Index (Non-Invest.Grade)	- 5.2% in 00	- 1.0% in 94	- 6.4% in 90
Citigroup Non-$ Bond Index (International Bonds)	- 9.2% in 05	- 5.0% in 99	- 4.2% in 97
JP Morgan Emerging Markets Debt Index (EM Debt)	- 0.8% in 01	-14.4% in 98	-18.9% in 94
Lehman TIPS Index (TIPS)	+ 2.8% in 05	+ 2.4% in 99	+ 3.9% in 98
DJ AIG Commodities Index (Commodities)	-19.5% in 01	-27.0% in 98	- 5.6% in 91

Data provided by Morningstar, DFA and PIMCO

(For ease of illustration, poor asset class performance that occurs in the same calendar year is highlighted using the same color.)

The optimization of an aggregate portfolio's risk exposure and investment results is a combination of the foresight to buy asset classes when they are (relatively) low and having the strength to sell them when they are (relatively) high within the context of the asset class guidelines of an overall portfolio asset allocation plan. Often, this rebalancing requires going against popular consensus such as:

"there is more risk not being in internet stocks"

"bonds are for losers"

A risk of not rebalancing due to inertia or complacency with an asset class that has experienced excellent short-term returns is similar to those of investors who chase past performance. Just because a specific asset class has done well in the short run does not mean that the specific asset class will continue to do well or outperform in subsequent years. The discipline of rebalancing allows investors to minimize the portfolio impact of "the bad years" for any given asset class.

Table 3 illustrates the total return of each asset class for the 3yr, 5yr and 10yr periods ending 3/31/06.

Table 3 – Recent Asset Class Periodic Total Return

Investment Asset Classes	Total Return in % as of 3/31/06		
Equities	**3yr**	**5yr**	**10yr**
S&P 500 Index (Domestic Large Cap)	61.0	21.5	135.8
Nasdaq Composite Index (Dom. Large Cap Growth)	74.5	27.6	114.3
Russell 2000 Index (Domestic Small Cap)	117.3	80.9	162.9
Wilshire REIT Index (REITs)	136.4	181.5	371.5
MSCI EAFE Index (International Large Cap)	125.5	58.4	87.5
MSCI EAFE Small Cap Index (Int'l Small Cap)	186.1	130.5	70.9
MSCI EMF Index (Emerging Markets)	215.4	188.1	107.3
Fixed Income	**3yr**	**5yr**	**10yr**
Lehman Aggregate Bond (Dom. Investment Grade)	9.1	28.4	84.4
CSFB High Yield Bond Index (Non-Invest.Grade)	41.2	56.9	101.0
Citigroup Non-$ Bond Index (International Bonds)	16.1	49.1	56.8
JP Morgan Emerging Markets Debt Index (EM Debt)	50.2	79.5	246.2
Lehman TIPS Index (TIPS)	14.9	41.8	N/A
DJ AIG Commodities Index (Commodities)	55.9	74.4	114.6

Data provided by Morningstar, DFA and PIMCO

It is worth noting that for some asset classes the 3yr total return is *higher* than for the 5yr and 10yr total return periods.

Consider that the 3yr total return for emerging markets equity is 215.4%, yet the total return for this asset class over the past 10yrs (which includes the past 3yrs) is only 107.3%.

That's a lot of volatility.

With the global markets at these levels, the concept of portfolio rebalancing has never been more important. Aside from greed, the most difficult challenge to the discipline of portfolio rebalancing is the realization of capital gains taxes. No one likes to pay taxes.

That being said, with a properly managed portfolio the majority of realized capital gains taxes should be long-term in nature. At 15%, the long-term capital gains rate has never been lower. With the recent performance of certain asset classes such as domestic and international small cap and emerging markets equities, REITs, commodities, and others, there is a high likelihood that some level of portfolio rebalancing, and capital gains realization, is necessary to maintain an intended level of risk.

Using a globally-diversified asset allocation strategy with a disciplined portfolio rebalancing program is a judicious and profitable investment approach. However, executed properly, the act of rebalancing requires the discipline to "sell high" and in most cases, pay some taxes. In markets like we have had for the last 3 years, these taxes can be sizable.

*'da Nile ain't a river in Egypt **

*denial isn't a river in Egypt

A good incentive to pay capital gains taxes as a risk management exercise now should be the inevitable administration change in 2008. Regardless of which party is elected in the next presidential election, it is likely the next administration will have to raise taxes to some degree given the growth of our federal budget deficit.

The Lam Group
To paraphrase Warren Buffett:

The key to happiness is to have low expectations.

Despite the volatility in February, performance for the first quarter of 2006 was unexpectedly strong, and the second quarter is off to a roaring start. We are happy to be properly diversified and expect to rebalance our portfolios as necessary and with tax-efficiency in mind.

While the direction of markets and investment asset classes in general are impossible to predict, we continue to believe that exposures to non-$ equity and fixed income markets as well as real assets, such as real estate and commodities, are essential diversifying elements for properly balanced portfolios.

The Lam Group continues to focus on designing and managing globally diversified investment portfolios and overseeing our client's portfolio risks by employing investment asset classes which have low relative correlation in the context of an aggregate portfolio.

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 accepting new clients on a referral-basis only, with a $2 million initial minimum.

Nelson J. Lam
The Lam Group, Inc.
P.O. Box 850
Lake Oswego, OR 97034
April 26, 2006

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	**1Q 2006**	**12 Mo.**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*+ 5.53%*	*+14.95%*	*+19.72%*	*+0.99*
US Total Market Fund	+ 3.67%	+10.55%	+19.26%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	*+ 4.21%*	*+11.72%*	*+17.21%*	*+1.00*
Domestic Large Cap Value Fund	+ 6.20%	+16.86%	+25.40%	+0.93
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*+12.93%*	*+25.82%*	*+33.04%*	*+0.84*
-Russell 2000 Index	*+13.94%*	*+25.85%*	*+29.53%*	*+0.83*
Domestic Small Cap Value Fund	+15.06%	+27.72%	+38.96%	+0.77
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*+15.79%*	*+42.24%*	*+33.18%*	*+0.37*
REIT Fund	+15.40%	+40.31%	+32.03%	+0.35
Real Estate Fund	+10.46%	+24.86%	+30.58%	+0.52
International Real Estate	+15.56%	+32.62%	+42.53%	+0.65
International Large Cap Stocks				
-MSCI EAFE Index	*+ 9.40%*	*+24.41%*	*+31.13%*	*+0.86*
International Large Cap Value Fund	+12.36%	+29.13%	+39.36%	+0.84
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*+10.13%*	*+31.46%*	*+41.96%*	*+0.69*
International Small Cap Value Fund	+12.68%	+30.20%	+46.13%	+0.59
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*+11.51%*	*+43.58%*	*+42.50%*	*+0.79*
Emerging Markets Value Fund	+13.69%	+44.68%	+54.91%	+0.75

* 5 yr correlation using monthly data

Fixed Income Asset Class Category	**1Q 2006**	**12 Mo.**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	*+ 0.42%*	*+ 2.41%*	*+ 1.52%*	*-0.53*
Short Duration Domestic Inv. Gr. Bond Fund	+ 0.16%	+ 2.01%	+ 1.88%	-0.33
Short Duration Domestic Muni Bond Fund	+ 0.35%	+ 2.03%	+ 1.45%	N/A
-Lehman Aggregate Bond Index	*- 0.65%*	*+ 2.26%*	*+ 2.92%*	*-0.37*
Domestic Investment Grade Bond Fund	- 0.53%	+ 2.66%	+ 3.63%	-0.32
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	*+ 3.10%*	*+ 6.61%*	*+12.20%*	*+0.53*
High Yield Bond Fund	+ 4.10%	+ 6.55%	+11.43%	+0.59
Inflation-Linked Bonds				
-Lehman TIPS Index	*- 2.25%*	*+ 0.86%*	*+ 4.75%*	*-0.29*
- Dow Jones AIG Commodities Index	*- 2.41%*	*+ 5.72%*	*+15.90%*	*+0.11*
TIPS Fund	- 2.06%	+ 0.81%	+ 5.24%	-0.29
Commodities-Linked Fund	- 5.59%	+ 2.29%	+18.20%	N/A
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*- 0.19%*	*- 6.48%*	*+ 5.10%*	*-0.16*
Non-$ Bond Fund	- 0.60%	- 7.13%	+ 4.80%	-0.11
Emerging Markets Debt				
-JP Morgan EMBI+ Index	*+ 1.48%*	*+13.83%*	*+14.53%*	*+0.36*
Emerging Markets Debt Fund	+ 1.22%	+14.73%	+15.06%	+0.45

* 5 yr correlation using monthly data