

The Lam Group

Investment Management

The Lam Group Newsletter Vol. 6, No. 3

Third Quarter 2006

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The Big Picture: Turning Storms into Smooth Sailing

The main objective of diversifying investments is to lower the overall risk of an aggregate portfolio. As we begin the fourth quarter of 2006, it is clear that this has been an important year to be well-diversified.

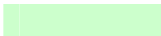
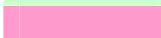

- In the first quarter, the domestic and international small cap, emerging markets equity, and REIT asset classes surged, while commodities and bonds (globally) struggled.

- In the second quarter, all the asset classes that surged in 1Q struggled (in some cases violently), and the commodity and non-\$ bond investments that performed so poorly in 1Q rallied in 2Q.

- In the third quarter, there was more volatility: domestic large cap equities, domestic bonds and REITs surged while commodities suffered, and domestic and international small cap equities were lackluster.

In 2006, while many individual asset classes have been on a performance roller-coaster, a globally-diversified and balanced portfolio, when considered in aggregate, has afforded investors a smooth, comfortable, and relatively uneventful ride.

<u>Asset Class Category</u>	<u>3Q 2006</u>	<u>2Q 2006</u>	<u>1Q 2006</u>	<u>2006 YTD</u>
<u>Equity</u>				
S&P 500 Index (Domestic Large Cap)	+ 5.67%	- 1.44%	+ 4.21%	+ 8.53%
Russell 2000 Index (Domestic Small Cap)	+ 0.44%	- 5.03%	+13.94%	+ 8.69%
Wilshire REIT Index (REITs)	+ 9.20%	- 1.20%	+15.79%	+24.93%
MSCI EAFE Index (International Large Cap)	+ 3.93%	+ 0.70%	+ 9.40%	+14.49%
MSCI EAFE Small Cap Index (Int'l Small Cap)	+ 0.41%	- 3.81%	+10.13%	+ 6.81%
MSCI EMF Index (Emerging Markets)	+ 4.10%	- 5.11%	+11.51%	+10.15%
<u>Fixed Income</u>				
Lehman Aggregate Bond Index (Dom. Invest. Grade)	+ 3.89%	- 0.80%	- 0.65%	+ 3.42%
Citigroup Non-\$ Bond Index (International Bonds)	+ 0.88%	+ 4.04%	- 0.19%	+ 4.75%
JP Morgan Emerging Markets Debt Index (EM Debt)	+ 6.55%	- 2.15%	+ 1.48%	+ 5.80%
Lehman TIPS Index (TIPS)	+ 3.63%	+ 0.49%	- 2.25%	+ 1.80%
DJ AIG Commodities Index (Commodities)	- 6.50%	+ 6.13%	- 2.41%	- 3.16%
DFA Global 60/40 Fund (balanced, ex commodities)	+ 2.83%	-0.63%	+5.25%	+7.55%

Surging = 
Suffering = 
Balanced = 

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Given the volatility of this year's first three quarters, the last quarter of 2006 will surely be difficult to navigate. That being said, a major tenet of our investment philosophy is that markets are impossible to predict, particularly in the near-term.

It is worth noting that despite arguments to the contrary by political/market conspiracy theorists, the recent explosive and unexpected performance of the domestic markets (large cap stocks, bonds and REITs) combined with the surprisingly steep drop in energy prices just weeks before this November's important mid-term elections is most likely to be coincidence.

That being said, with October's annual market volatility (due in part to the 10/31 tax year-end for mutual funds) and the general uncertainty regarding possible congressional leadership changes in November, anything can happen in the short-run.

Over the long-run, however, the balancing effects of properly-diversified portfolios will mitigate much of the short-term volatility experienced by the underlying individual asset classes. To achieve this, patience and a focus on the aggregate portfolio are required.

About the recent volatility in the commodities markets

The commodity markets have already felt the short-term effects of the massive decline in value of the energy-oriented Amaranth hedge fund. The on-going liquidation of Amaranth's positions and the ultimate closure of this highly-leveraged fund may put additional pressures on different market sectors and various capital markets participants through the end of the year.

Obviously, when using a multi-asset class diversification strategy, at any one point in time, some asset classes will be up and others will be down. To build a properly-diversified investment portfolio, it is important to add asset class investments whose risk/return characteristics have *low correlation* (i.e. behave differently) to the core domestic equity and fixed income holdings to *lower* the overall risk of the aggregate portfolio. Conversely, to add asset classes that behave similarly (*high correlation*) would *add* risk to an aggregate portfolio.

Some may express concern about the recent volatility in the commodities market, however, it is important to remember why commodities were included in the portfolio in the first place. Historically, commodities have had extremely low correlation to domestic stocks and bonds, and as a consequence, are an important diversifying element for an aggregate investment portfolio.

In periods (such as 2Q 2006, 2005, 2004, 2002 and 2000) where the performance of domestic equities (especially large cap stocks) were lackluster (or negative), commodities carried the day with excellent results. Conversely, in recent periods, such as 3Q and 1Q 2006, where the strong performance of domestic large cap equities have surprised many (including us), commodities have lagged meaningfully. As domestic large cap equities and commodities have low correlation with each other, *this relatively inverted performance relationship is precisely why a diversified portfolio should own both asset classes.*

The recent decline in the value of commodities would be more worrisome if other asset classes had not gone up. Fortunately, the strong recent performance of domestic large cap stocks (and domestic bonds and REITs) demonstrates their low correlations to the commodities asset class.

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While it is never pleasant to experience investments that have lost value in the near-term, it is important to realize that over the long-term the diversifying effects of a properly-selected combination of investments of low-correlated asset classes is an effective approach to managing aggregate portfolio volatility.

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As The Lam Group approaches completing our fifth year as an investment management firm, we are grateful to our clients and friends who have supported and helped us grow the firm a level where our balanced investment approach, and belief in passive-asset class management is gaining recognition as a unique, tax-sensitive, and low-cost way to manage portfolios for taxable families.

Media Appearances

While it continues to be the policy of our firm to keep a low-profile, we are fortunate to have made several appearances in the media over the last few weeks:

- Wall Street Journal – Getting Going, September 20, 2006
- Wall Street Journal – Sunday Journal, October 1, 2006
- Business Week – Personal Finance, October 13, 2006

Growth and Expansion

As a consequence of our growth in both number of clients (now 31) and assets under management (over \$200 million), I am pleased to announce that my wife, Bettina (Tina) S. Lee, has joined The Lam Group as a Managing Director and will serve as the firm's Chief Operating Officer.

Tina's responsibilities at The Lam Group include managing day-to-day operations, assisting with compliance matters, as well as developing our training program and our alternative asset class research capabilities.

Prior to joining The Lam Group, she was a Principal at SmartForest Ventures (SFV) in Portland, OR, a venture capital firm with over \$65 million in assets under management. At SmartForest, Tina was responsible for sourcing early-stage venture capital deals, researching new technologies and evaluating technical and management teams. She served as a voting member SFV's investment committee.

Before coming to Oregon, Tina was a senior executive in the Equity Derivatives Department at Bankers Trust (now Deutsche Bank) in New York, and managed the some of the firm's largest and most sophisticated institutional hedge fund manager relationships. Her prior professional experience included technical/engineering positions at Bell Labs.

She holds a Master of Business Administration (MBA) from the Harvard Business School and a Bachelor of Arts (BA) in Computer Science and Master of Engineering (ME) in Electrical Engineering from Cornell University.

Tina was born in 1961 and raised in New York City. She is the mother of our three sons.

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Dimensional Fund Advisors

As our clients know, The Lam Group is fortunate to have access to the Dimensional Fund Advisors (DFA) family of institutional mutual funds. DFA has recently announced that sometime in 2007, it will close some of its US small cap equity strategies to new investors. The DFA funds are noteworthy because they offer “pure” asset class exposures and have extremely low expense ratios. At this time, the closings will be “soft”, meaning that existing investors (and existing clients of The Lam Group) will continue to be able to put new money in these funds.

The news of the DFA fund closings is only meaningful to those who have an interest in becoming clients of The Lam Group because the funds that will be closed play an important role in our overall asset allocation strategy and balanced approach. While alternative domestic small cap equity funds can be substituted for the DFA funds, potential clients who want us to use the best tools to implement our unique strategy should consider initiating a formal relationship with The Lam Group before DFA closes these funds to new investors.

At this time, we are accepting new clients on a referral-basis only, with a \$2 million initial minimum.

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October 10, 2006

Archives for The Lam Group Newsletter are available at our website: 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 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.

<u>Equity Asset Class Category</u>	<u>3Q 2006</u>	<u>2006 YTD</u>	<u>3 Year Annualized</u>	<u>Correlation w/ S&P 500*</u>
<u>Domestic Total Equity Market</u>				
-Wilshire 5000 Index (Total Dom. Eq. Market)	+ 4.31%	+ 8.06%	+13.28%	+0.99
US Total Market Fund	+ 4.52%	+ 8.01%	+13.19%	+0.99
<u>Domestic Large Cap Stocks</u>				
-S&P 500 Index	+ 5.67%	+ 8.53%	+12.30%	+1.00
Domestic Large Cap Value Fund	+ 2.90%	+11.23%	+19.10%	+0.92
<u>Domestic Small Cap Stocks</u>				
-CRSP 6 -10 Index	- 0.01%	+ 6.64%	+15.98%	+0.83
-Russell 2000 Index	+ 0.44%	+ 8.69%	+15.48%	+0.82
Domestic Small Cap Value Fund	- 0.70%	+10.36%	+21.65%	+0.76
<u>Real Estate Investment Trusts (REITs)</u>				
-Wilshire REIT Index	+ 9.20%	+24.93%	+27.41%	+0.38
REIT Fund	+ 9.21%	+24.15%	+26.46%	+0.37
Real Estate Fund	+ 8.89%	+18.50%	+25.03%	+0.53
International Real Estate	+ 7.26%	+17.11%	+27.98%	+0.63
<u>International Large Cap Stocks</u>				
-MSCI EAFE Index	+ 3.93%	+14.49%	+22.32%	+0.84
International Large Cap Value Fund	+ 6.47%	+19.74%	+28.13%	+0.79
<u>International Small Cap Stocks</u>				
-MSCI Small Cap EAFE Index	+ 0.41%	+ 6.81%	+26.21%	+0.64
International Small Cap Value Fund	+ 3.15%	+13.09%	+28.46%	+0.54
<u>Emerging Markets Equity</u>				
-MSCI Emerging Markets Free Index	+ 4.10%	+10.15%	+27.25%	+0.77
Emerging Markets Value Fund	+ 6.34%	+16.12%	+37.77%	+0.73

* 5 yr correlation using monthly data

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<u>Fixed Income Asset Class Category</u>	<u>3Q 2006</u>	<u>2006 YTD</u>	<u>3 Year Annualized</u>	<u>Correlation w/ S&P 500*</u>
<u>Domestic Investment Grade Bonds</u>				
-Lehman 1-3 year Govt Bond Index	+ 2.01 %	+ 3.11%	+ 2.02 %	-0.45
Short Duration Domestic Inv. Gr. Bond Fund	+ 2.35%	+ 2.91%	+ 2.35%	-0.28
Short Duration Domestic Muni Bond Fund	+ 1.23%	+ 2.14%	+ 1.49%	N/A
-Lehman Aggregate Bond Index	+ 3.81%	+ 3.06%	+ 3.38%	-0.31
Domestic Investment Grade Bond Fund	+ 3.88%	+ 3.04%	+ 3.95%	-0.23
<u>Domestic High Yield Bonds</u>				
-CSFB High Yield Bond Index	+ 3.54%	+ 7.16%	+ 9.09%	+0.55
High Yield Bond Fund	+ 1.32%	+ 7.67%	+10.07%	+0.59
<u>Inflation-Linked Bonds</u>				
-Lehman TIPS Index	+ 3.63%	+ 1.80%	+ 4.89%	-0.32
- Dow Jones AIG Commodities Index	- 6.50 %	- 3.16%	+12.89%	-0.02
TIPS Fund	+ 3.38 %	+ 1.84%	+ 5.04%	-0.32
Commodities-Linked Fund	- 4.81%	- 5.36%	+14.31%	N/A
<u>International (non-US \$) Bonds</u>				
-Citigroup Non-\$ World Govt Index	+ 0.88%	+ 4.75%	+ 4.41%	-0.14
Non-\$ Bond Fund	+ 0.39%	+ 3.81%	+ 3.58%	-0.10
<u>Emerging Markets Debt</u>				
-JP Morgan EMBI+ Index	+ 6.55%	+ 5.80%	+11.25%	+0.43
Emerging Markets Debt Fund	+ 6.31%	+ 5.51%	+11.86%	+0.51

* 5 yr correlation using monthly data

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Past Performance is no guarantee of future results.