The Lam Group
Investment Management

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The Big Picture: The Things We Think and Do Not Say*

What would we do without the private equity market? These large pools of unregulated money seem to be everywhere, buying anything and everything, and lately, it seems the bigger the target investment, the better.

And why not? These guys have the money: In 2006 private equity firms raised $246.3 billion. So far, 2007 is off to an impressive start with $44.3 billion raised in 1Q 2007 with at least another $130 billion in the process of being raised**.

Whether the recent spending spree initiated by private equity firms will turn out to be astute, only time will tell. However the "private equity bid" has handsomely pushed up prices in the public equity markets, and investors who only have access to public market investments should be nothing but grateful.

For the uninitiated, private equity firms generally consist of two components: the manager (the general partner) who raises and invests the capital; and the investor (the limited partner or client) who puts up the cash for the manager to invest. Private equity firms buy publicly traded companies (take them private), in order to reorganize and improve them, so they can be resold to the public.

The managers of private equity funds generally require their investors to agree to a compensation scheme that includes an <u>annual</u> 2% management fee as well as a 20% share of any profits - commonly known as "2% and 20%". It is worth noting that with most private equity firms, the management fee is only paid on money that is invested. This means that private equity managers have an incentive to deploy their investors' funds quickly, regardless of how high public market valuations may be. Over the last several years, private equity firms have doubled their annual management fees from 1% to 2% without much fanfare or complaints from willing institutional and private investors.

Show me the money!

The allure of fee income is strong. The $246.3 billion in private equity funds raised in 2006 will generate approximately $4.9 billion in <u>annual</u> management fees for the private equity managers, regardless of whether the actual investments make any money. For the larger funds, the annuity represented by the management fee alone is a home run for the manager. One has to wonder how these investment professionals stay sharp (and hungry) as they look for companies to buy.

* A The Lam Group coffee mug to the first reader who can identify the movie this quote came from.
**Dow Jones Private Equity Analyst.

With all that money and such a lucrative compensation structure, there is no doubt that the business of being a private equity investment manager is wonderful. But is being private equity investor (a limited partner) a worthwhile endeavor, particularly in the current investment climate?

In the old days, private equity investment meant the acquisition of a damaged or dented public company, often in a backwater industry during a period of a lackluster economy and weak equity markets. By taking an underperforming public company private, the new owners could streamline operations, rid itself of sub-optimal personnel and unnecessary business units, refocusing the company to be more attractive to the public markets. In many ways, private equity investment was the corporate precursor to many of the "extreme makeover" reality shows we now see on television.

A robust stock market often allowed the private equity managers to reintroduce their "refurbished" companies to the public markets, often at enormous profits for the private equity managers and their investors. In the old days, the key to successful private equity investing was to buy a company cheaply (preferably in a depressed stock market) and improve its prospects in time to take advantage of a rebounding and potentially eager stock market.

In the past, the bulk of the money in private equity investments was made when a "liquidity event" occurred, such as an IPO or corporate acquisition of the rebuilt company. Central to this success was a thriving economy and/or public equity market. This "buy low, sell high" sensibility was simple to understand and profitable to both the private equity managers their investors.

The share prices of public companies are at or near all-time highs and public stock markets are in their fifth consecutive year of positive returns. At the same time, private equity firms have raised record-breaking amounts of capital. With all this capital, is it still possible for private equity managers to find suitable companies to buy?

To this question, a manager of a large private equity firm might answer:

With a 2% annual management fee on billions of dollars, who really cares?

The things we think and do not say.

In addition to paying the exorbitant management fee, the private equity investor is at the mercy of the manager in several other ways. As private equity investments are typically long-term in nature, they are highly illiquid; with no public market to value the investments, the management fee calculation is completely reliant on the manager for the ongoing valuation of the investment. While a company is in transition, or being "made over", what is its value, and how transparent is the valuation process? Until a true liquidity event occurs, valuation and transparency are issues that put the interests of the manager and the investor in direct conflict.

While it is easy to be critical of private equity firms with their oversized assets, asymmetrical compensation structures, conflicts of interest, and lack of transparency, investors in public equity markets should be grateful that someone is willing to buy some of the largest and highly valued companies amid a five year run up in the stock market.

Private equity firms, however, may get the last laugh. Despite extolling the virtues of “going private” to enhance profitability and attractiveness of their investments to their clients, many of the largest and most successful private equity firms (Blackstone, Apollo, et al.) have recently disclosed plans to take themselves public. When a firm that is making “2% and 20%” on billions of dollars decides it is time to sell, what does that mean for the rest of us?

Despite the volatility in late February, performance of our client portfolio’s for the first quarter of 2007 exceeded expectations, and the second quarter is off to a roaring start - thanks in part to the strong private equity bid in the public market. We are happy to be properly diversified and expect to rebalance our portfolios as necessary and with tax-efficiency in mind.

The Lam Group
In tournament golf, scores are kept for money. A player merely has to touch the ball fewer times than the competition to win. While this seems simplistic and almost easy, it is not. To successfully and consistently get the ball in the hole by touching it the fewest times takes skill, experience, patience, and requires a solid understanding of risk and reward before a ball is even hit. A winning player must have the ability to make difficult and timely decisions and execute them under changing and often challenging circumstances.

A portfolio management strategy using globally balanced and diversified-asset class approach works in the same manner. The investment manager must have skill, experience, patience, and a solid understanding of risk and reward before a dollar is invested. With passively-managed asset classes to efficiently gain the necessary investment exposures, “touching” the portfolio as little as possible minimizes transactions costs and taxes. This approach allows us to optimize aggregate return, manage overall risk and keep unnecessary expenses low.

The Lam Group continues to focus on designing and managing globally diversified investment portfolios and overseeing our client’s risks by only including investment asset classes which have low relative correlation in the context of an aggregate portfolio. Our asset allocation approach employs 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.

In 2007, we will begin to limit the number of new clients we will work with in the future. This limitation is to preserve the quality of our work and the direct access our current clients enjoy with us. The Lam Group will continue its policy of considering new clients on a referral-basis only, now with a $5 million initial minimum.

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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	**1Q2007**	**12mo.**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*+ 1.48%*	*+11.43%*	*+11.13%*	*+0.99*
US Total Market Fund	+ 1.36%	+11.25%	+10.92%	+0.99
Domestic Large Cap Stocks				
-S&P 500 Index	*+ 0.64%*	*+11.83%*	*+10.06%*	*+1.00*
Domestic Large Cap Value Fund	+ 2.01%	+15.44%	+15.44%	+0.93
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*N/A*	*N/A*	*N/A*	*N/A*
-Russell 2000 Index	*+ 1.95%*	*+ 5.91%*	*+12.00%*	*+0.81*
Domestic Small Cap Value Fund	+ 3.07%	+ 8.89%	+16.40%	+0.76
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*+ 3.62%*	*+21.85%*	*+24.09%*	*+0.37*
REIT Fund	+ 3.49%	+21.31%	+23.15%	+0.37
Real Estate Fund	+ 3.46%	+21.93%	+22.18%	+0.56
International Large Cap Stocks				
-MSCI EAFE Index	*+ 4.08%*	*+20.20%*	*+19.83%*	*+0.86*
International Large Cap Value Fund	+ 5.04%	+24.41%	+24.95%	+0.81
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*+ 7.10%*	*+15.55%*	*+23.32%*	*+0.65*
International Small Cap Value Fund	+ 9.06%	+24.27%	+26.86%	+0.58
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*+ 1.80%*	*+17.93%*	*+24.45%*	*+0.77*
Emerging Markets Value Fund	+ 7.42%	+30.32%	+34.65%	+0.74

* 5 yr correlation using monthly data

Fixed Income Asset Class Category	1Q2007	12 mo.	3 Year Annualized	Correlation w/ S&P 500*
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	*+ 1.40%*	*+ 5.15%*	*+ 2.40%*	*-0.43*
Short Duration Domestic Inv. Gr. Bond Fund	+ 1.65%	+ 5.30%	+ 2.72%	-0.20
Short Duration Domestic Muni Bond Fund	+ 0.86%	+ 3.37%	+ 1.79%	-0.02
-Lehman Aggregate Bond Index	*+ 1.50%*	*+ 6.59%*	*+ 3.31%*	*-0.27*
Domestic Investment Grade Bond Fund	+ 1.70%	+ 6.32 %	+ 3.67%	-0.17
Domestic High Yield Bonds				
-CSFB High Yield Bond Index	*+ 3.02%*	*+11.84%*	*+ 8.74%*	*+0.51*
High Yield Bond Fund	+ 4.40%	+12.45%	+ 9.56%	+0.59
Inflation-Linked Bonds				
-Lehman TIPS Index	*+ 2.51%*	*+ 5.30%*	*+ 2.98%*	*-0.30*
TIPS Fund	+ 2.55%	+ 5.00%	+ 3.08%	-0.29
-DJ AIG Commodities Index	*+ 4.60%*	*+ 9.39%*	*+ 8.16%*	*-0.04*
Commodities-Linked Fund	+ 5.61%	+ 8.46%	+ 7.13%	N/A
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*+ 1.09%*	*+ 8.32%*	*+ 2.71%*	*-0.14*
Non-$ Bond Fund	+ 1.07%	+ 7.58%	+ 1.86%	-0.10
Emerging Markets Debt				
-JP Morgan EM Global Bond Index	*+ 2.39%*	*+10.86%*	*+10.42%*	*+0.46*
Emerging Markets Debt Fund	+ 2.13%	+10.77%	+10.85%	+0.51

* 5 yr correlation using monthly data