The Lam Group

Investment Management

The Lam Group Newsletter Vol. 9, No. 1
Spring 2009

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The Big Picture: Fall Back, Spring Ahead

As global equity markets have advanced simultaneously since March 9th, many investors are asking the question:

Have we seen the bottom?

Obviously, it would be wonderful we have, however, we will only know the answer when it is history. The better question may be:

Is the current rally sustainable?

While the current rally in equities may be indicative of some level of traction for the massive monetary and fiscal stimulus programs implemented over the last six months, it may also be as a consequence of technical factors (e.g. rumors of the reinstatement of the uptick rule, proposed changes in mark-to-market accounting regulations), emotional reactions (e.g. reassuring statements from the Fed and the new administration), or psychological factors (investors do not want to miss the beginning of the recovery rally) that can all have explosive short-term effects on the equity markets.

While the gains in the global equity markets since the March 9th lows have been intoxicating, we remain cautious and wary of premature confidence. Despite the unprecedented monetary and fiscal stimulus programs, the global economy continues to decline. Growing unemployment and housing inventories combined with shrinking consumer demand indicate there are still significant challenges that need to be overcome before confidence in a recovering economy can be inspired.

Can the economy recover if it is still hard to borrow?

The answer may be found by examining investment-grade credit spreads. Credit spreads are illustrative of the most basic form of investment risk premium: for a given maturity, how much additional yield (spread) does an investor require to receive to over US Treasury debt to lend to a non-Treasury entity. Credit spreads reflect bond investor confidence and capital markets supply.

It is worth noting that the credit markets, as measured by investment-grade corporate bond spreads, have only moderately tightened in 2009 from the historically-wide levels reached in late 2008. The implication is that credit, while perhaps no longer in crisis, is only in the nascent stages of recovery and that bond market investors are less convinced the economy is on the road to recovery than equity market investors. Historically, sustainable rallies in the equity markets have occurred in the presence of robust capital markets (tight and/or tightening credit spreads).

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It is our opinion that a broad rally in the equity markets may not be sustainable until credit spreads recover significantly from their current levels. Credit spreads are a metric we are watching carefully.

It is possible that credit spreads remaining at their wide current levels may foretell upcoming challenges facing the banking system, the looming refinancing needs of the commercial real estate markets and the impending reorganization and/or bankruptcy of the US auto industry. Depending upon the severity of these challenges, it is likely that these issues, and possibly others, will put additional strain on the capital markets.

However, every dark cloud has a silver lining. With credit spreads at current levels, short-term domestic investment-grade corporate bonds (now yielding between 6% and 9%) have attractive return characteristics with much lower volatility than equities. To put this lower volatility in context, over the last four months (2009 YTD thru April), short-term domestic investment-grade corporate bonds returned +3.58% (with little spread tightening) while the S&P 500 returned -2.50%.

If credit conditions improve, it is likely that both equities and investment-grade corporate bonds will do well (equities will likely do better given how much further they have fallen). However, if credit conditions do not improve, investment-grade bonds may have more palatable risk/return characteristics than equities.

That being said, the wholesale risk aversion all markets experienced in the fall of 2008 seems to be subsiding and there are signs that many asset class relationships are returning to historical norms. Some asset classes, such as TIPS, corporate bonds, and emerging markets debt, all of which failed to provide diversification benefits to the portfolio during the 4Q2008 deleveraging period, have shown meaningful diversification contributions in 2009.

While it is anyone's guess if the equity markets will rally tomorrow, it is important to remember that "picking the bottom" is not part of our investment strategy. History has shown that successfully timing the market is extremely difficult to do consistently and that a balanced and globally diversified portfolio with a disciplined rebalancing strategy is central to long-term investing success.

The Lam Group: Designated Driver

In the first two months of 2009, the global equity markets were down substantially and there was an overwhelming sense of despair amongst the general investing population. It seemed as though the equity markets got pounded daily, beyond anyone's expectation or imagination. Media outlets such as CNBC fanned the flames of panic. By the first week of March, questions of, "is this time truly different?" and "should we go to cash?" were prevalent; even our most sophisticated clients and investment management colleagues expressed concern. During this period, we had many conversations with our clients and friends about the unpredictability of markets, the mathematics of risk and expected return, and the importance of portfolio allocation discipline and balance.

Since March 9th, the global markets have rallied substantially and despite the many challenges facing the global economy and markets, questions of, "have we seen the bottom?" and "is it time to get back into stocks?" are coming from all corners. The answers to these questions are similar to the answers we

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gave earlier in the year: Markets are unpredictable, markets adjust to give riskier investments a higher expected return, and overall risk should be mitigated through portfolio diversification and rebalancing.

Especially after the last six months we have suffered, rallying equity markets can be intoxicating. However when the underlying fundamentals of the credit markets and the economy are still in doubt, the seemingly euphoric equity market conditions may be comparable to when one drinks too much alcohol on an empty stomach. It is possible to have impaired judgment and unwarranted confidence.

While it remains to be seen if we are at the beginning of a prolonged bull market for stocks, it would be a mistake to make investment decisions with long-term implication based on only two to four months of highly volatile market activity. Especially in uncertain times like these, it is more important than ever to stay disciplined in the context of a long-term portfolio asset allocation plan that owns a mix of asset classes.

The Lam Group is an independent, fee-only, SEC-registered investment advisory firm with 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, and foundations.

Our Firm has been structured to provide our clients with an investment management relationship that enjoys the highest degree of transparency and avoids any conflicts of interest. This transparency, combined with the intellectual honesty of using passively-managed asset classes in our asset allocation strategy, is the foundation of our overall investment philosophy and approach.

We continue our policy of considering new clients on a referral-basis only.

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May 4, 2009

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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.

All data is as of 04/30/09

Equity Asset Class Category	April 09 YTD	12 Mo	3 Year Annualized	Correlation w/ S&P 500*
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	*- 1.16%*	*-34.69%*	*-10.73%*	*+1.00*
US Total Market Fund	- 1.32%	-34.47%	-10.66%	+1.00
Domestic Large Cap Stocks				
-S&P 500 Index	*- 2.50%*	*-35.31%*	*-10.76%*	*+1.00*
Domestic Large Cap Value Fund	- 3.32%	-41.66%	-15.07%	+0.97
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	*N/A*	*N/A*	*N/A*	*N/A*
-Russell 2000 Index	*- 1.81%*	*-30.74%*	*-12.72%*	*+0.93*
Domestic Small Cap Value Fund	- 1.15%	-34.69%	-16.44%	+0.91
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	*-12.21%*	*-50.77%*	*-18.71%*	*+0.80*
REIT Fund	-11.63%	-48.90%	-18.15%	+0.80
International Real Estate	- 8.65%	-54.39%	N/A	N/A
International Large Cap Stocks				
-MSCI EAFE Index	*- 2.92%*	*-42.76%*	*-12.34%*	*+0.91*
International Large Cap Value Fund	- 0.75%	-44.44%	-12.60%	+0.93
International Small Cap Stocks				
-MSCI Small Cap EAFE Index	*+ 4.33%*	*-42.38%*	*-16.61%*	*+0.84*
International Small Cap Value Fund	+ 0.90%	-39.94%	-12.81%	+0.86
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	*+17.75%*	*-42.90%*	*- 5.51%*	*+0.82*
Emerging Markets Value Fund	+16.84%	-44.78%	- 4.37%	+0.86

* 5 yr correlation using monthly data

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All data is as of 04/30/09

Fixed Income Asset Class Category	April 09 YTD	12 Mo	3 Year Annualized	Correlation w/ S&P 500*
Domestic Investment Grade Bonds				
-Barclays 1-3 year Govt Bond Index	*+ 0.17%*	*+ 4.54%*	*+ 5.76%*	*-0.31*
Short Duration Domestic Inv. Gr. Bond Fund	+ 1.06%	+ 4.29 %	+ 5.83 %	-0.02
Short Duration Domestic Muni Bond Fund	+ 1.66%	+ 3.86%	+ 3.52%	+0.01
-Barclays Aggregate Bond Index	*+ 0.59%*	*+ 3.84%*	*+ 6.01%*	*+0.19*
Domestic Investment Grade Bond Fund	+ 2.39%	+ 3.45%	+ 6.95%	+0.17
Domestic High Yield Bonds				
-Barclays High Yield Bond Index	*+18.81%*	*-13.28%*	*-1.16%*	*+0.74.*
High Yield Bond Fund	+12.08%	-12.78%	- 1.45%	+0.70
Inflation-Linked Bonds				
-Barclays TIPS Index	*+ 3.55%*	*- 1.79%*	*+ 5.11%*	*+0.28*
- Dow Jones AIG Commodities Index	*- 5.64%*	*-46.50%*	*-11.58%*	*+0.39*
TIPS Fund	+ 3.53%	- 1.64%	N/A	N/A
Commodities-Linked Fund	+ 1.06%	-50.82%	-11.94%	+0.42
International (non-US $) Bonds				
-Citigroup Non-$ World Govt Index	*- 5.16%*	*- 2.26%*	*+ 6.58%*	*+0.18*
Non-$ Bond Fund	- 6.03%	- 4.81%	+ 4.86%	+0.19
Emerging Markets Debt				
-JP Morgan EMBI+ Index	*+ 8.95%*	*- 4.52%*	*+ 3.78 %*	*+0.64*
Emerging Markets Debt Fund	+ 7.30%	-10.49%	+ 1.82%	+0.66

* 5 yr correlation using monthly data

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