

Quarterly Investment Commentary | April 2007

Equities rebounded in March, putting returns back on positive ground for the year. Both the large-cap S&P 500 (as measured by the Vanguard 500 Index Fund) and the small-cap Russell 2000 iShares gained 1.1% for the month. Year to date through March, the S&P was up 0.6%, while the Russell 2000 gained a more robust 1.9%. The Russell Midcap iShares benchmark lagged slightly in March, with a 0.8% gain, but its 4.3% year-to-date gain outpaced both of large and small stocks on the market-cap spectrum. Foreign equities had a strong month, gaining almost 3%, and posted a first-quarter return of almost 4%. On the fixed-income side, Vanguard Total Bond Market Index Fund was flat in March, but was up 1.4% for the quarter. Emerging markets short-term bonds and commodity futures both performed well in the first quarter.

What's rattling the Market?

After enjoying a seven-month run of mostly climbing stock prices, investors were spooked by the big drop in the Chinese market in late February, and the subsequent dip in U.S. stock prices. Fears that a slowdown in the Chinese economy will impact global growth was one concern, and the magnitude of the one-day drop that happened in the U.S. markets was another. We'll address the latter first.

We are long-term investors, and so shorter-term market declines that are driven by fear rather than fundamentals represent opportunities to us. By way of context, a 3.5% one-day loss is by no means unprecedented and is not by itself a big source of concern. **The market had gained almost 14% in the seven months prior to the recent retrenchment, and investors may have been concerned about giving back those gains.** We also took comfort from our observation that big market declines have generally been preceded by stretched valuations, and this is probably not an issue right now. There is some uncertainty in that the extent to which hedge funds and program selling can impact the market are unknown, and their influence is a new development that could potentially cause disruptions regardless of the current valuation picture. But, if their activities caused a correction that moved prices from fairly valued to cheap, that would be a good example of where we can use our long-term time horizon to capitalize on shorter-term swings in valuation.

In terms of the fear that stock market declines in China foreshadow a global economic slowdown, we were a little surprised to see the markets react as they did. The Chinese A-share market is mostly limited to domestic Chinese investors, so any movement in that market is of questionable relevance to an outside, developed economy like the U.S. It is true that the economic expansion in both the U.S. and China has been going on for a long time, and investors know that at some point the cycle will ebb. Any evidence suggesting that this

March Benchmark Returns (Preliminary)		
	Mar.	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	1.1%	0.6%
Russell 1000 Growth iShares	0.5%	1.1%
Russell 1000 Value iShares	1.5%	1.2%
Mid-Cap Benchmarks		
Russell Mid cap iShares	0.8%	4.3%
Russell Mid cap Growth iShares	0.5%	3.9%
Russell Mid cap Value iShares	1.1%	4.8%
Small-Cap Benchmarks		
Russell 2000 iShares	1.1%	1.9%
Russell 2000 Growth iShares	0.9%	2.5%
Russell 2000 Value iShares	1.2%	1.4%
Other Benchmarks		
Vanguard Total Int'l Stock Index	2.8%	3.9%
Vanguard REIT Index	-2.4%	3.4%
Vanguard Total Bond Mkt Index	0.0%	1.4%
Merrill Lynch High-Yield Bonds	0.2%	2.7%
Salomon Brothers World Gov't Bond	0.2%	1.2%
DJ-AIGCI (Commodity Futures)	1.0%	4.6%
JPMorgan ELM1 +	1.9%	2.2%

could be materializing sooner rather than later is likely to concern investors. On that note, another potential contributor to a slowdown is the housing market, and problems in the subprime lending market in particular.

Subprime Loans

Most of us—especially those living in areas with very high housing costs—are aware that lenders have pushed the envelope in recent years to come up with loans to enable people to buy homes they would otherwise be unable to afford. In so doing, many of these buyers have stretched themselves financially to the point where they have no margin for error. With rates having climbed, and low starter rates and temporary interest-only terms winding down or expiring, defaults among subprime mortgages have climbed sharply. Consider that loans in this segment accounted for 24% of originations in 2006, defaults in this sector are in the 13% to 14% range, and some subprime lenders have either experienced big financial losses or gone out of business

Looking more closely, however, the picture is not as clear. The growth in subprime originations has moved in lockstep with a decrease in Federal Housing Authority loans (FHA borrowers are typically first-time home buyers who are unable to make a meaningful down payment). In a recent report from Ned Davis Research, they explain this as follows: “Essentially, the private market filled a void created by the federal government. ... The failure of federal rules to keep up with changes in the marketplace allowed the subprime lenders to expand their market share by 10 percentage points at the expense of government-backed loans. If it weren't for the easier lending practices this cycle, we would have expected little economic impact relative to what we had seen previously, since this effectively was a change in loan composition, not loan quality.” **As of year-end 2006, more than 76% of all loans outstanding were still prime loans. This means that even if the combined subprime/FHA sector had a default rate of 20%—well above the prior peak in 2002—fewer than 5% of outstanding loans would be impacted. While this would be enough to cause pain, it would probably not be enough to result in a disaster for the economy.**

The downside is more likely to be that defaults and tighter lending standards will mean that growth in the subprime arena will stall, as PIMCO predicts, and this could cause demand to sag further up the “food chain.” PIMCO believes—and this is one of the more bearish views we've read—that we're still only in the middle of the housing downturn, and that this will ultimately cut roughly 1% from GDP growth over the next few quarters (and that there is at least some risk that it could be worse). Clearly that's not good, but it is also not as bad as the outcome many seem to expect given the extensive media play that the problems have received.

Earnings Will Be the Key

Developments like a slowdown in China or a crunch in subprime lending would definitely impact the economy, perhaps significantly. **The real question, though, is not whether they will have an impact, but rather how much of that potential risk is already reflected in stock prices.** This is a question we regularly ask ourselves, and having access to lots of good data, we can take a careful look at market history and come up with some assumptions to use in the context of the current environment. **If the market has already discounted these events, then maybe we need not worry about them as much.**

The way we typically tackle this topic is to imagine what a bearish scenario might look like in terms of earnings and P/E multiples for the S&P 500. Since the price of the S&P 500 is a function of the underlying earnings and the P/E multiple applied to those earnings, we can simply take a bearish earnings number and put a best-guess P/E multiple on top of it to arrive at a prospective target price for the S&P 500. We can then compare this target price to today's

price to see what kind of return this implies over a multi-year period. If the return is decent, it tells us the market is already discounting a negative scenario.

We'll start with earnings. How bad is bearish when it comes to earnings? There's no magic answer to that, but historically, it has been very rare for nominal earnings to end any five-year stretch at a lower level than they began. That gives us some context, but we're not willing to rely solely on history—we also want to do the math. Earnings are a function of how much money companies take in (revenues) and the profit margin on those revenues. If we assume corporate revenues will increase at roughly the rate of inflation over the next five years (which is pretty bearish), and at the end of that time period we apply a historically average profit margin (which implies a material decline from the current level of profit margins), we come up with an earnings number for the S&P 500 that is somewhere in the low \$80s. This is around the level of current earnings, and thus would comprise a five-year earnings scenario that is in line with prior periods of extended and noteworthy earnings weakness (in other words, a pretty bearish earnings scenario).

What would this mean for stock prices? To get at that, we must put a multiple on top of those earnings (see table below if you want to cut to the chase). One might assume that a poor earnings environment would result in an overall glum mood for investors—one where they weren't willing to pay as much for stocks (meaning the market would trade at a relatively low P/E ratio). Historically, however, P/E multiples have been higher at the earnings low point than the historical average P/E and higher than the P/E during the prior earnings peak. The reason is that the market is forward looking, and so even when things are really bad at a point in time, investors are already looking ahead to what comes next.

Since 1950, there have been 12 earnings troughs. The average P/E ratio during those troughs was about 20 (the median was 18). The last time we saw a trough earnings multiple of 12 or less was 1983 (and interest rates were very high at that time, which pushes valuation multiples lower). The four troughs since then all saw multiples above 20. There are many variables that influence how much investors are willing to pay for a dollar of earnings, but the historical data gives us some confidence that, in general, stock multiples hold up fairly well during earnings declines.

Armed with that data, we can make a table that shows us the expected return from equities in some scenarios, assuming a starting point of 1420 for the S&P 500 (it's level on March 30), and including the impact of dividends.

Five-Year S&P 500 Returns* Under Various Earnings and P/E Scenarios							
Earnings five years from now:	\$70	\$80	\$90	\$100	\$120	\$140	
Implied earnings growth rate*:	-4%	-1%	1%	3%	7%	10%	
P/E multiple {	12x	-8%	-6%	-3%	-1%	2%	5%
	16x	-3%	0%	2%	4%	8%	12%
	20x	2%	4%	7%	9%	13%	17%
	24x	5%	8%	11%	13%	17%	21%

*Returns and implied earnings growth rates are annualized.
 Shaded areas indicate returns that are better than the likely return from bonds.

For us to say that the market is already discounting a bearish scenario, we'd want to see decent stock market returns even if that scenario comes to pass. **There are a lot of ways we could define "decent," but one good one is that stocks do better than bonds.** The shaded regions in the table represent pre-tax returns that are equal to or better than the potential return range for bonds over the same time horizon.

When looking at the probable returns in a bearish environment, it does not appear that the market is fully discounting that scenario. A five-year period of flat earnings is not common, but is far from unprecedented. Given the risks posed by the housing market, the extremely high level of profit margins (which will be difficult to sustain), the fact that current earnings are far above their trend growth line, and the fact that the economic cycle is already longer than average, a bearish outcome is not a stretch.

However, these are all cyclical risks, which, while more notable than average, are not enough to cause us to run for the exits. Cycles are normal, and the challenge is in evaluating how big those risks are, and in differentiating cyclical risks from events or developments that are likely to cause lasting damage. One thing we've learned is that the world is a scary place. In the past 20 years, we can point to many events—including the stock market crash in 1987, fears of a major banking collapse, wars in the Persian Gulf, the Asian currency crisis and near-collapse of Long-Term Capital Management, panic over Y2K, and the deflation scare in 2002, to name just a few—that were serious causes for concern and in some cases led investors to panic in the short term, but that didn't end up having lasting negative consequences. The table shows us some pretty unpleasant scenarios for stocks, but these are just possible outcomes on the negative side and we don't think they are likely enough or damaging enough to justify avoiding stocks. On the other side, even modest earnings growth and an average P/E multiple results in returns that are better than bonds, so remaining invested in stocks still offers a likely reward. For example, if earnings simply grew in line with inflation (say, 3%) and we put the 25-year average P/E multiple of 20 on top of those earnings, we'd get a 9% return from equities. **We also believe that our managers can add value above the market—or more specifically their benchmarks—over longer time frames, and that would be an additional source of return for our clients.**

Our analysis might seem at odds with what we've said about valuations being attractive. **Right now, valuations look good when computed based on the current price of the S&P 500 and the current earnings of the S&P 500.** However, valuation work is different from scenario forecasting, although both are important and related to one another. As we've mentioned in many of our prior communications, we view risks—including a meaningful slowdown in earnings—as being above average, and the data in the table on page 18 represent one way of evaluating how much of those risks are already priced into the market. The answer seems to be that valuations are probably in the right ballpark, but they don't fully price in the possibility of a major earnings slowdown over the next five years.

If stocks aren't a compelling opportunity, is there a better place to invest? Investor sentiment always suggests there is a better place to be (though it's rarely right). In taking a look at other asset classes that factor in to our investment strategy, we'll start with international equities, which have been generating a lot of buzz lately.

International Equities

Recently, we've been getting more and more questions about how we determine our weighting to international stocks. We have been, and will continue to be opportunistic investors. Although we've just finished a period where international stocks have outperformed U.S. stocks five calendar years in a row, and by more than nine percentage points annualized, we still believe there are better investment opportunities outside the US. We rely on our international managers to pick the right countries, sectors and asset classes. Although the US stock market is "fairly" valued now, our International managers invest in China, Japan, developed Europe, emerging markets (Eastern Europe, Russia, Mexico, Latin America) etc. As economies have improved around the world, we are more comfortable with the added diversification our International managers give us by investing in many different companies and currencies around the world. If these investments continue to outperform we will most certainly take some profits and reduce our exposure, but we are comfortable with the 15% - 20% allocation to International equities we currently have.

REITS

REITs have been exceptional performers for the past several years, and through March, REITs are up another 3.4% (as measured by Vanguard REIT Index Fund). REIT fundamentals still appear to be improving, on average. Most property types are seeing increasing demand, while supply remains constrained, which is enabling REITs to increase rents. Strengthening fundamentals, combined with gradual increases in rent, should correspondingly improve the security of REIT dividends. Meanwhile, demand from both retail and institutional investors continues to be very strong. Retail investors continue to invest very heavily in REIT mutual funds, and in 2006, over \$5 billion went into REIT funds, which is the second highest annual level ever. Institutional investors also continue to be aggressive buyers of REITs.

Despite this positive backdrop, REIT valuations appear expensive relative to long-term average valuations. One metric we look at is how REIT stocks trade in relation to the estimated value of their underlying assets, or net asset value (NAV). Based on this measure, REITs are trading at an 11% premium to NAV, which is expensive (but not excessive) relative to the historical average. However, we are not putting too much weight on valuation metrics that rely on NAV estimates because, in recent years, Wall Street analysts have been increasing their estimate of property values to align their valuations with private market pricing. One possibility is that NAV estimates have risen too rapidly, which could be suppressing the overvaluation of REITs. In the past, we felt that a plausible argument could be made that real property was undervalued relative to other financial assets (and therefore property values, or NAV, was actually being understated), but this argument is difficult to make now that estimates of property values have increased so much. Another REIT valuation metric we look at is the Price/AFFO ratio, which is similar to a P/E ratio for equities. Based on this measure, for which we have roughly 10 years of data, REITs appear very overvalued. On a yield basis, REITs are trading very expensively relative to Treasuries by historical standards, also suggesting that REITs are overvalued. We have sold our domestic REIT funds, but are looking at possibly investing in a global REIT fund if we conclude the overall valuations are more attractive.

In Closing

Sometimes months and quarters go by with only incremental changes to our overall assessment of asset classes and the broader economic environment. It can be helpful to look over longer periods to see the gradual evolution in our thinking. What do we see if we look back from this point? At the end of the second quarter of last year we were coming off a difficult stock market environment that resulted in attractive valuations. In the period since, stocks have generated strong returns. Meanwhile, earnings growth has begun to slow, and developments that we think are probable—such as declining profit margins, further declines in earnings growth, and an overall economic slowdown—have moved closer. The result is that while current valuation metrics show stocks as undervalued, we think a forward-looking assessment suggests a more tempered view.

As always, we will continue to challenge the assumptions that underlie our view, consider new information as it becomes available, and stay intellectually honest in making well-reasoned investment decisions for our clients. We appreciate your confidence and trust.

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—Lido Advisors Investment Team (4/9/07)

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