

Quarterly Investment Commentary | January 2008

For the most part, with respect to the ranking of investment returns, the fourth quarter of 2007 was consistent with the rest of the year. In general, commodity prices moved sharply higher, as they did over the full year. Emerging-market equities and currencies continued their advance. Developed country foreign equities declined, a reverse after a strong advance earlier in the year—but they still out returned the U.S. equity market, which was down across all styles in the fourth quarter. Value continued to under perform growth in the fourth quarter, this time on the downside—and was in the red on the year. Growth stocks delivered decent positive returns for the full year. Small-caps continued to lag large-caps and were also in the red for the year. REITs' collapse intensified, as they dropped almost 13% in the fourth quarter alone. As recession fears increased, bonds performed well in the quarter and ended up with a solid 7% return for the year—ahead of the broad stock market.

December Benchmark Returns (Preliminary)			
	Dec.	4Q	YTD
Large-Cap Benchmarks			
Vanguard 500 Index	-0.7%	-3.4%	5.4%
Russell 1000 Growth iShares	-0.4%	-0.8%	11.6%
Russell 1000 Value iShares	-1.0%	-5.8%	-0.3%
Mid-Cap Benchmarks			
Russell Midcap iShares	-0.3%	-3.6%	5.4%
Russell Midcap Growth iShares	0.2%	-1.7%	11.2%
Russell Midcap Value iShares	-1.1%	-6.0%	-1.6%
Small-Cap Benchmarks			
Russell 2000 iShares	-0.1%	-4.6%	-1.5%
Russell 2000 Growth iShares	0.6%	-2.1%	6.9%
Russell 2000 Value iShares	-0.8%	-7.3%	-9.9%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-2.3%	-1.2%	15.5%
Vanguard REIT Index	-5.1%	-12.9%	-16.5%
Vanguard Total Bond Mkt Index	0.2%	3.1%	6.9%
Merrill Lynch High-Yield Bonds	0.3%	-1.1%	2.2%
Citigroup World Govt. Bond Index	-0.5%	3.9%	10.9%
DJ-AIGCI (Commodity Futures)	4.6%	4.7%	16.2%
JPMorgan ELM I +	0.6%	4.4%	16.0%

2007 Retrospective

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in homebuilding or lending were crushed. **The stock of the average homebuilder dropped over 50% (and over 70% going back to the pre-2007 peak) and financial stocks in general were pummeled.**

Household names like Fannie Mae, Freddie Mac, Washington Mutual, Countrywide Financial, Citigroup, Merrill Lynch, and Bear Stearns were among the firms caught in the mortgage market meltdown. As credit tightened and the housing market suffered, investors became more and more worried about the overall economy, triggering stock declines for many consumer goods companies. **While all this was**

going on, U.S. exports were booming and reached an all-time high of 12.1% of GDP (as of 9/30/07).

Not surprisingly, companies with significant foreign-based earnings did well including (generally) energy, technology, and materials companies. Overseas stocks also delivered great returns. **Related to the overseas story was the continuation of demand for energy and raw materials commodities from China and other high-growth developing countries.** This trend was also reflected in the strong performance of the energy and materials-related sectors.

S&P 500 Sector	Foreign Exposure (%)	YTD (%)
Energy	54.7%	27.1%
Information Technology	54.1%	15.6%
Materials	45.3%	21.3%
Consumer Staples	41.3%	9.0%
Industrials	36.8%	12.0%
Average	46.4%	17.0%
Health Care	36.1%	4.5%
Consumer Discretionary	24.7%	-9.4%
Financials	17.7%	-18.1%
Utilities	8.1%	14.7%
Telecommunications	3.4%	7.1%
Average	18.0%	-0.2%

There was action in the bond market also. Investors first worried about inflation and then recession. At times

they worried about both. The 10-year Treasury yield ranged from a **high of 5.25% in June** to a **low of 3.85% in November**. The best action was overseas as the dollar's drop gave U.S. investors currency gains that enhanced their returns. But outside of the government bond market, perceived credit risk rose, leading to underperformance.

For Lido it was a year when each of our tactical asset allocation moves added value versus our benchmarks. Our three asset class plays continue to be: 1) an overweight to large cap growth stocks (the Russell 1000 growth index returned +11.6% in 2007 while the Russell 1000 value index declined .3%) 2) an overweight to International equities (the MSCI EAFE index gained 9.6% in 2007 while the S&P 500 Index gained only 5.4%) 3) continue to overweight our hedged/alternative category. These investments posted strong risk adjusted returns with low correlation to the US equity markets.

Remaining Focused is Key in the Age of Information Overload

**"Everybody gets so much information all day long that they lose their common sense."
— Gertrude Stein**

In the trenches of the money management business it is a constant struggle to avoid information overload while staying on top of the right information. The amount of analysis and data and the breadth of information available amounts to a tsunami compared to what we had access to 10 years ago. We think of ourselves as research junkies so we'd rather have more than less. But, it takes discipline to stay focused on the right information and not get distracted by the (sometimes interesting) less relevant information. Sometimes it takes creativity and persistence to find the data or research that we need to get to the right conclusions. **Even with the challenges that we face with an information explosion, one thing hasn't changed, and that is the critical importance of a common sense overlay that brings us back to what really matters and helps us resist the temptation to either overanalyze or make decisions based on knee-jerk reactions.** We think this common sense is one of our strengths.

So what matters most right now? Two things:

- The underlying economic and investment fundamentals
- Understanding what is reflected in current security prices

There are other things that matter when it comes to portfolio construction, such as the scenario analysis we do, but with respect to assessing competing investment opportunities—which is what investing is all about—these two areas are where we focus our attention. In each of these the challenge is the same: to sift through a seemingly limitless supply of information and determine what is most important. An additional challenge is to stay intellectually honest about what we can confidently know or assess and what we can't. (A variable may be very important but unpredictable or unknowable, like, say, next month's inflation rate.) One of the common failings of amateur and professional investors alike is thinking that they are smarter than they really are, i.e., overconfidence. All it takes is a few right calls to start believing you're Nostradamus.

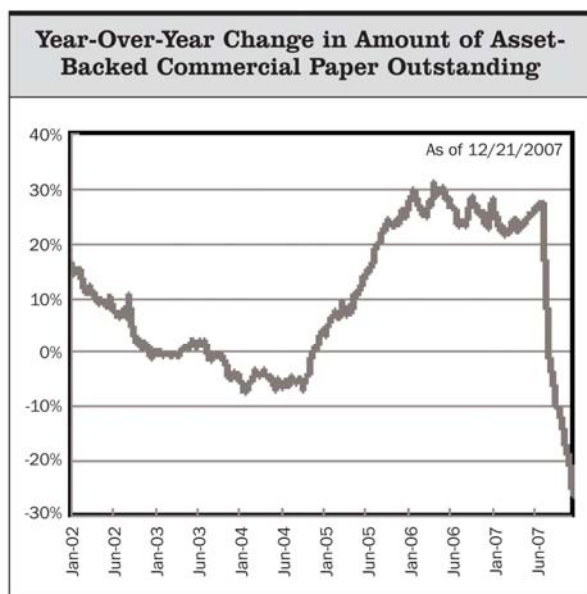
Another challenge is finding the right balance in communicating our thoughts to you. On the one hand, we like to give you enough detail so that you can understand the basis for our investment decisions and know we do our homework. **On the other hand, too much information and this commentary becomes a cure for insomnia.** We know this is one area where we can do better but if you find the detail to be too much (and you want to stay awake) you can always cut to the chase by going straight to the conclusion. We make these points because (boring or not) they provide a framework for understanding how we think and make decisions. With that, we'll offer our take on where we think we stand after a very eventful year.

2008: Big Worries ... Any Opportunities?

As you know, our investment decisions are always made based on a multi-year outlook. This allows us to focus on underlying fundamentals and valuations—the factors that ultimately drive returns — and distance ourselves emotionally from the day-to-day “noise” of the markets and the financial media. Over shorter time periods these relationships—between fundamentals, valuations, and returns—don’t always hold. This is the point made in the legendary Benjamin Graham saying “In the short-term the market is a voting machine but in the long-term it is a weighing machine.” However, we are not totally unconcerned with performance over periods as short as one year because we manage all of our portfolios based on a targeted one-year loss threshold. This loss threshold is something we are thinking about as we head into 2008.

The question most investors are asking at this point is: **will the troubled housing and mortgage industries take down the economy?** The underlying key is consumer spending, which makes up 70% of the economy. The contraction in the housing-related industries has a direct impact on employment and spending, but it is the related credit crunch and its impact on spending that could cause the most damage.

The impact of hundreds of billions of dollars in loan losses to banks, hedge funds, and other investors means less ability to lend, because lenders have less capital. It also means less willingness to lend because they are unsure about the borrowers (including other financial institutions, because the lack of transparency makes it difficult to assess bad debt exposure) and because they have to keep high



Demand for asset-backed commercial paper has dropped off of a cliff, reflecting an unwillingness and, in some cases, an inability to lend.

quality assets (cash) on their balance sheets to cover their own potential losses. Moreover, capital has increasingly come from outside the banking system (hedge funds, non-bank financial institutions, and other unregulated investors through a variety of “structured” vehicles), making it tougher for the Fed to restore confidence and liquidity. It is worth noting that because of global capital markets, the pain has spread beyond the U.S. and is being felt in the European financial markets.

The problem is that it is difficult to quantify the losses and impossible to confidently forecast how restrictive credit will be and for how long. There is also fear that credit problems will spread to other areas, with credit cards being one area of concern because of permissive underwriting standards. **At this point it seems pretty clear that banks will have more write-offs over the next few months or quarters and that structured investments (securitized pools of debt), which are often highly leveraged,**

will suffer through more ratings downgrades as collateral values decline further. Certain types of hedge funds, which have exposure to these vehicles, are likely to suffer sizable losses in coming months. Moreover, it is very likely that lending practices will be generally more conservative, suggesting slower growth in credit for a sustained time period. A predisposition to conservative lending will make the Fed’s job harder. This suggests that the current trend of less credit and higher costs probably has a way to go. This is true not just in the mortgage market (subprime and prime) but in the consumer and small-business loan market as well.

It is easy to dwell on the negatives and this is a common investment mistake that we've seen (and sometimes made) over many years. **It is not a foregone conclusion that the negatives will drag the economy into recession—though some slowdown seems quite likely.** Although the employment market is showing some signs of slowing (unemployment claims are starting to rise), it remains healthy. Corporate earnings outside of the financial sector are still growing. Emerging markets continue to thrive and are a positive for the global economy. A weaker dollar has helped support a boom in U.S. exports. The Fed and other central banks are aware of the economic risks and are using interest-rate policy and other measures to improve liquidity. They will not stop until they have an impact, though how quickly this will happen and how successful they will be is not yet clear. **Overall, global liquidity remains strong with large foreign exchange reserves and huge growth in sovereign wealth funds (government controlled investment funds created to invest foreign exchange reserves), two indicators of liquidity.** There are already some tangible examples of available liquidity, including recent investments in major but troubled financial institutions (Morgan Stanley, Merrill Lynch, UBS, Citigroup, and Bear Stearns) by Chinese, Singaporean, and Middle Eastern investors. As we weigh the information we have, we know we can't confidently predict how the macro picture will play out. **However, we believe the odds of a meaningful slowdown or even recession have moved sharply higher from a few months ago, though a recession is still far from certain.**

That there is big-picture uncertainty is nothing new—it's always a given. And as always it begs the question: **what is priced into the markets?** This is important because at times the relationship between the macro climate and security prices disconnects. **When fear is high, investors avoid risk, driving up the prices of safe assets and driving down the prices of riskier assets—often to excess.** The result is that riskier assets usually are bargain priced when fear is high, and vice versa. Presently most "risky" assets (anything other than cash and investment-grade bonds) do not appear to be bargain priced despite all the worries. But mostly they are not expensive and some sectors look to be very cheap from a long-term standpoint. One quick valuation reality check is to look at trailing returns for riskier asset classes. When trailing returns are very high, especially over a lengthy period, chances are that the asset class is richly priced. But when returns have been low or average for a long period, chances are the asset class is undervalued or fairly priced. **Currently, trailing longer-term returns are not so high as to suggest inflated asset class valuation levels.**

Trailing Returns of Riskier Asset Classes

As of 12/31/07	S&P 500 Index	Russell 2000 Index	Merrill Lynch High-Yield	NAREIT Equity Index	MSCI EAFE Index	MSCI Emerging Markets
1 year	5.5%	-1.6%	2.2%	-15.7%	11.6%	39.8%
3 years	8.6%	6.8%	5.5%	8.5%	17.3%	35.6%
5 years	12.8%	16.2%	10.6%	18.2%	22.1%	37.5%
10 years	5.9%	7.1%	5.8%	10.5%	9.0%	14.5%
15 Years	10.5%	10.1%	7.7%	13.0%	9.9%	12.2%
20 Years	11.8%	11.3%	8.9%	12.3%	7.8%	16.3%

Additional details of our analysis and thinking on selected asset classes follow:

U.S. Equities: Our evaluation of stocks focuses on one-year risk and long-term return potential. A key factor we've been focusing on over both time periods is earnings.

In aggregate, earnings have already declined over the past year. However, this is mostly due to steep write-offs in the financial sector, which make up about 20% of the S&P 500. **Excluding financials, earnings growth was strong through the third quarter (about 11% year over year)—but again, financials are a big part of the market and a critical sector in the economy.** Moreover, we know that earnings are highly correlated with the economy, so the weaker the economy, usually the bigger the earnings decline. So it's not just a matter of whether or not the economy experiences a recession. Economic strength is all a matter of degree, so even without an official economic recession, an anemic period of growth could trigger an "earnings recession." That would be a headwind for stock

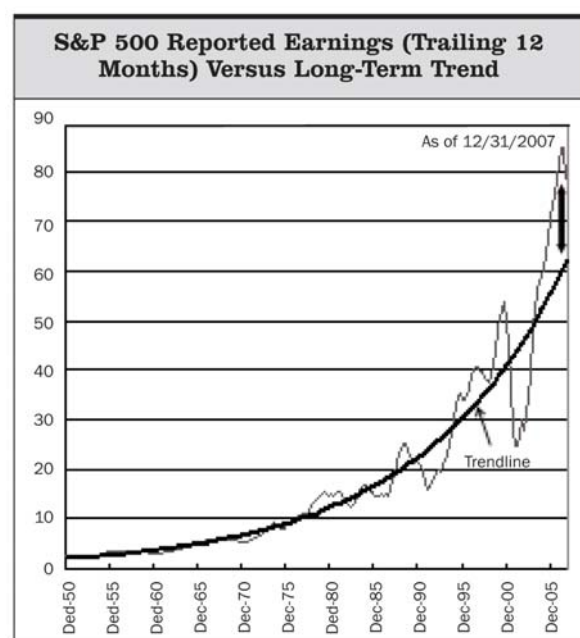
prices. If there is a full-blown recession, earnings could fall 10% to 20% from their peak. Earnings also tend to fall back below their long-term trend line in recessions. This would suggest an even larger decline because earnings are currently far above trend. It is very possible that there will be some near-term earnings risk, depending on how much economic growth slows and for how long. The Fed would help offset some of the damage in an earnings recession by taking already low interest rates even lower. This seems the direction we are headed, and it would likely encourage investors to look to recovery and also ensure that fixed-income investments would not provide much competition. However, lower rates will not eliminate the risk to stock investors from a material earnings recession.

What level of risk is priced into stocks? As we go to press, stocks are down about 12% from their peak. Most of our valuation measures suggest the market is in the range of fair value and some measures suggest stocks are at bargain levels. However, we've also looked at valuation assuming current earnings are at inflated levels (since they are way above their long-term trend and profit margins are historically high). And we've looked at past bear markets to see what has happened to multiples at earnings troughs and also at bear market bottoms. **This is important because P/E multiples are almost always higher when earnings are depressed (investors anticipate a rebound in earnings) and lower when earnings are inflated (investors anticipate a slowdown in earnings growth).** Any assessment of these variables also must take into account interest rates. Looking at past bear markets and the relationship between these variables, and using the most conservative outcomes over the past 25 years, suggests that P/Es would be in the low 20s or even higher at a bear market bottom assuming the 10-year Treasury yield is around 5% (if the 10-year Treasury yield is below 5% as it is now, the bear-market bottom P/E might be higher than 20x). This suggests the potential for a 10% to 12% decline in stock prices from current levels. **If a stagflation scare (which seems unlikely in the near term given the deflationary pressure from housing and credit markets) pushes the 10-year Treasury higher to, say, 6%, the stock market could fall by more than 25%. This is a very pessimistic scenario and would qualify as a severe bear market.**

This analysis, based on a study of historical data, is useful, but we're sensitive to the reality that history doesn't always repeat so that it is dangerous to confidently anchor to indicators based on the past few bear markets. For example, common sense suggests that it would be unlikely for the S&P 500 to decline back to levels first touched 10 years ago—which was two years before the tech bubble peaked—but that is the level to which a further 25% decline would take it.

Clearly the stock market is not pricing in a recession at this point, but it does seem to be discounting some slowdown in earnings growth. At present, Wall Street consensus earnings growth forecasts for 2008 are still over 10%, and if these prove to be accurate stocks will probably do well. However, it is worth noting that analysts seem to wear rose-colored glasses when looking at companies: they have never successfully foreseen an earnings recession.

As we've noted, when taking a longer-term view, stocks look fairly valued and on some measures undervalued. This is particularly true relative to interest rates. However, corporate earnings and profit margins are well above their long-term historical average (profit margins are at a 50-year high), and if we adjust for a gradual reversion,



Earnings are way above their long-term trend, mostly due to very high profit margins.

stocks look to be closer to the expensive end of a fair-value range. We believe that profit margins are unsustainably high and therefore earnings growth will be subpar—either the result of a short but sharp drop in earnings, or from a sustained period of slower growth. If this happens, stock returns are likely to beat bond returns but would probably not reach double-digit levels. This also assumes that interest rates stay within one percentage point of current levels.

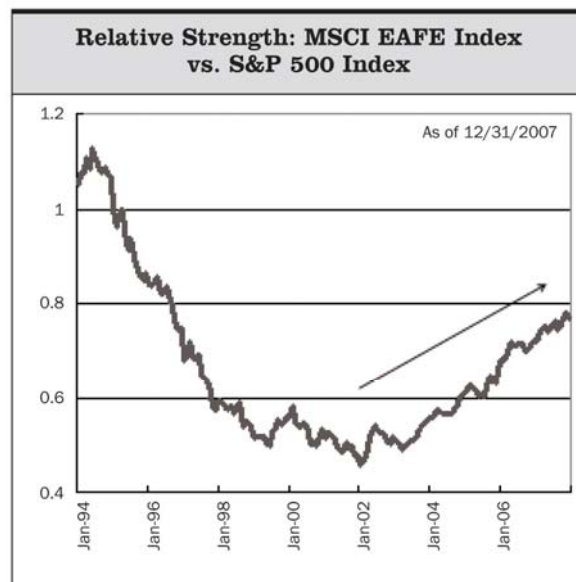
The most negative environment (though not the most probable) over our five-year time horizon would be a period of stagflation—a risk that may increase (though not in the near term) if we see excessive monetary reflation in the fight to offset falling housing prices and tighter credit, and continued excess demand for commodities driven by China, India, and other developing countries. Such a period would be characterized by below-average earnings growth along with rising inflation and interest rates. This suggests the possibility of somewhat disappointing stock market returns over the next five years, possibly as low as or slightly lower than bonds, depending on the relationship between earnings growth and inflation—but, at this point, we don't view this as even close to a base-case outcome. There is also the possibility of upside surprise. The Fed could engineer a soft landing, with money growth, ample global liquidity, emerging market demand, and productivity increases that spur another several years of earnings growth and healthy stock returns.

A source of encouragement comes from many (but not all) of the equity fund managers we follow who tell us that they are finding more compelling opportunities now than they have in the last few years. This may be due to the large variance in performance in different sectors that could be creating opportunities for stock picking. This is unlike the last several years when we were hearing that there were not a lot of valuation discrepancies. **So, while the overall market has underlying questions, we are somewhat more optimistic about the potential to add value from good stock picking.** However, good values don't always result in good short-term returns—they are more of a statement of long-term return potential.

We continue to like large-cap stocks much more than small-cap stocks—from a valuation, earnings, and cyclical perspective—and we continue to overweight growth over value.

Foreign Equities: As a generalization, foreign equities can be divided up between developed and developing (emerging) markets. **Developed market equities had a great year in 2007 and have outperformed U.S. stocks for six consecutive years.** They still look to be within a fair-value range compared to the U.S. However, both Europe and Japan, like the U.S., are showing signs of an economic slowdown. We also view currency as a potential risk. The strong decline of the dollar versus the euro suggests that the euro is now overvalued and there is a risk of a currency reversal. The euro's strength has also hurt the competitiveness of the manufacturing sector. However, we do continue to overweight foreign equities because of the number of different economies and currencies we get exposure to.

Emerging Markets Local Currency Short-Term Bonds: As a generalization, emerging markets are growing rapidly, have large trade surpluses and foreign currency reserves, and have reduced debt levels. Though there will be



After a long period of underperformance in the 1990s, stocks domiciled in developed foreign markets have now had a strong six-year run compared to U.S. stocks.

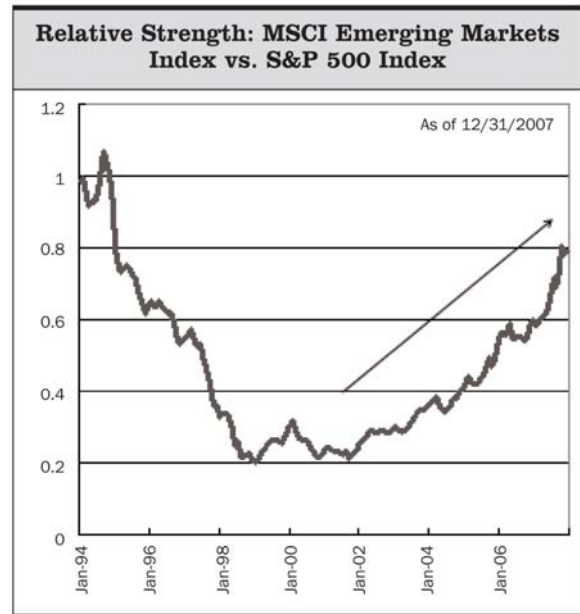
A rising line means foreign stocks are returning more than U.S. stocks.

temporary setbacks, this suggests a strong case for a continued bull market in emerging-markets currencies. Moreover, as China continues to allow its currency to appreciate versus the dollar, this creates room for other emerging-market governments to allow their currencies to rise as well. This asset class continues to be an area of exposure in our portfolios both for the currency play and, secondarily, for the current yield.

There is some uncertainty about how these markets will perform in a global recession. There is a possibility of a flight to the dollar as a “safe haven” in an uncertain environment—which would not be good for emerging markets currencies. On the one hand, emerging-markets economies—based on current fundamentals—are generally likely to hold up better and probably continue to grow. Dollar appreciation versus emerging markets would exacerbate emerging markets’ economic advantage and potentially trigger U.S.-based trade tensions. These risks would already be inflated in a time of U.S. economic weakness. Governments of emerging markets countries, with their large currency reserves, would be inclined to support their currencies versus the dollar in this environment. So a sustained drop in emerging-market currencies in a recession seems unlikely unless their economies turn out to be much more vulnerable than is generally believed.

REITs: REITs have been clocked this year, losing 16.5%. In fact, we have to go back to the mid-1970s to recall a worse period for REITs. The brutal sell off, which picked up steam in the fourth quarter, has brought REITs back to fair-valued territory or better. Whether they are undervalued may depend on whether the appreciation in underlying properties over the last several years holds. But we wouldn’t be surprised to see some decline in property values (increasing cap rates), especially with financing less available and pricier. On the plus side, the structural shift in institutional investors’ allocation to real estate may still have a way to go, though this move is probably in the late innings. We have a small allocation to global REITs, but have been out of US REITs for sometime.

Alternative investments: Alternative investments were a big winner in our portfolios in 2007. We continue to view our alternatives as a valuable diversifier that provided strong risk adjusted returns in 2007. We are prohibited from discussing specific investments (compliance reasons), but all but one of our investments in our alternative category out performed the market (S&P 500) with substantially less risk. A couple of these investments achieved these strong risk adjusted with 30 – 40% in cash



Emerging markets stocks have experienced a huge run and almost completely reversed their horrible performance of the mid- to late 1990s.

A rising line reflects emerging markets outperforming the U.S. stock market.



After a huge run up, REITs have been in a bear market for the last nine months.

reserves. We continue to overweight a couple of these opportunistic absolute return funds as we have a high level of confidence these management teams can navigate through these volatile markets and produce positive returns in any market environment.

Fixed Income: Investment-grade bonds are the primary way to hedge against recession risk and though Treasury yields are quite low now (because expectations of economic weakness are priced in), some slices of the investment-grade market offer more attractive yields. For example, a significant yield pick-up is available in the agency bond sector. Longer-term return potential is limited given today's yield levels—returns are likely to fall between 4% and 6% (annualized) over the next five years. **This makes bonds unlikely to be able to keep pace with stocks except in our most bearish scenarios, which is why we continue to underweight them in favor of our alternative investments.** However, we are considering increasing investment-grade bond exposure as a hedge against an economic downturn.

As for taking much credit risk to capture extra yield, in our view it's too late in the economic cycle. High-yield defaults are likely to rise over the rest of the cycle. Losses from defaults and price declines, as yields have to rise to attract investors, will hurt returns. We don't think current junk bond yields are high enough to compensate us for this risk.

Conclusion

Most equity-oriented asset classes are priced around fair value. Large-cap stocks remain attractive relative to small-cap stocks—so the former are overweighted and the latter underweighted in our portfolios. But our overall equity exposure is neutral. We continue to have tactical weights to emerging-markets currencies (through short-term bonds) and as previously mentioned we have an overweight to our opportunistic alternative managers. All three of these allocations added value in 2007.

Economic risk has risen and recession is a clear possibility, though not necessarily a high probability. However, we are taking a close look at the risk exposure in our portfolios and assessing whether we should increase our defensiveness. Because our scenario analysis suggests that our portfolios can withstand a normal recession without violating 12-month risk thresholds, any moves we make are unlikely to be dramatic. **However, clients should understand that the possibility of a rough year lies ahead. They should also understand that this is not an outcome that can be predicted with high confidence.** We've been surprised by positive market returns many times over the years. So we focus on doing our best to maintain adequate risk protection over a one-year time horizon based on the risk tolerance of each investor, while keeping our eye on the more important goal of long-term returns. This common sense approach has served our clients well in all market environments.

If the current turmoil in the credit markets and/or an economic downturn triggers a severe sell-off, we are likely to see tactical opportunities created in several asset classes or at a stock-picking level. In fact, at a stock-picking level we may already be at this point, with some large financial firms selling far below what their fair value would be if (after the credit crisis abates) their earnings return to normalized levels. However, given the fear and uncertainty, it is likely to be a while before their stocks reflect their longer-term potential. At an asset-class level we are not there yet—and we may not get there soon—**but for long-term investors, market turmoil can create great opportunities.**

—Lido Advisors Investment Team 1/10/08

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