

Quarterly Investment Commentary | July 2007

After an uninspiring first quarter, stocks around the world surged in the second quarter. Domestically, bigger was better, with larger companies delivering the highest returns, followed by mid-caps and then small-caps. Though small-caps did well in the first quarter, they now lag large-caps over the past year—though all market-cap segments have performed well in absolute terms. It was also a good quarter for growth stocks. Fueled by the second quarter's returns, growth indexes have now out-performed value indexes for the year to date in all market-cap segments. International stocks had another strong quarter and out-performed the U.S. market again. **The performance of these two asset classes (growth stocks & international stocks) enabled our portfolios to significantly outperform the Vanguard Balanced Index and in most cases the all equity S&P 500 Index the first 6 months of the year.** We over weighted both these asset classes at the beginning of the year.

Non-equity asset classes were mixed. Emerging-market short-term bonds (PIMCO Developing Local Markets) performed very well and added a lot of value relative to the U.S. bond market, which was slightly negative for the quarter and only slightly positive for the year. Commodity futures were negative for the quarter though still positive for the year. REITs suffered a sharp correction, losing 9% during the quarter and have now experienced an 18% decline since peaking in early February.

June Benchmark Returns (Preliminary)		
	June	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	-1.7%	6.9%
Russell 1000 Growth iShares	-1.5%	8.0%
Russell 1000 Value iShares	-2.3%	6.2%
Mid-Cap Benchmarks		
Russell Midcap iShares	-2.3%	9.8%
Russell Midcap Growth iShares	-1.8%	10.9%
Russell Midcap Value iShares	-2.8%	8.6%
Small-Cap Benchmarks		
Russell 2000 iShares	-1.3%	6.6%
Russell 2000 Growth iShares	-0.6%	9.3%
Russell 2000 Value iShares	-2.3%	3.7%
Other Benchmarks		
Vanguard Total Int'l Stock Index	0.6%	11.9%
Vanguard REIT Index	-9.3%	-6.3%
Vanguard Total Bond Mkt Index	-0.4%	0.8%
Merrill Lynch High-Yield Bonds	-1.7%	3.0%
Salomon Brothers World Gov't. Bond	-0.6%	-0.4%
DJ-AIGCI (Commodity Futures)	-1.4%	4.5%
JPMorgan ELMI +	0.7%	6.1%

Market Update

In every economic cycle there are points where the indicators are particularly confusing. During these times investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times.

- Early in the year investors worried that the troubles in the housing market might lead to a recession. As economic activity weakened, interest rates dropped and stocks lost about 5% of their value—bottoming in early March.
- Shortly thereafter, concerns about recession dissipated and optimism improved. Investors began to believe in a not-too-hot and not-too-cold Goldilocks economy, and the buy-out boom added to the bullish mood. The stock market took off, rising 12% from early March into early June. At the end of this run the S&P 500 finally surpassed its previous high—set over seven years ago in March 2000.

- Early in June, investors began to fear inflation and further interest rate increases. The strength in the global economy, the need to rebuild inventories, and declining productivity began to dash investor hopes of a Fed interest rate cut later in the year, despite the weakness in the U.S. housing market. The bond market sold off, with the 10-year Treasury yield hitting levels not seen for over five years. Stocks began following suit in early June with a drop of about 3% over three days.
- But then, the market briefly righted itself, helped by better (lower) than expected core inflation numbers.
- As the quarter closed, the stock market dropped back near its low for the month as mixed signals on the economy, credit market fears, and concern that the buy-out tail wind might slow, collectively seemed to leave investors generally confused and increasingly cautious

At Lido Advisors we've never believed we could add value using an investment strategy that relied on accurate forecasts of the economy over the near term. In fact, we believe it's a particularly difficult area to master, which is perhaps why Laurence Peter (*The Peter Principle*) once said that **"an economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today."** We've probably expressed our views on economic forecasting at least one time too often, but this year is such a great example of why we hold these views that we couldn't resist.

The risk of feeling like a dog chasing its tail, by reacting as economic data shifts from week to week or month to month, is exacerbated by the intense coverage of the financial media and the comments on the part of professionals in the media. Recently, after a particularly bad day in the market, an investment advisor was quoted in the *Wall Street Journal* as saying that he had sold all the stocks in his personal account and gone completely to cash for the first time in 20 years. It is remarkable that he apparently is sure that this market environment is (by inference) even riskier than "the bubble" which, earlier this decade, led to the worst bear market since the 1930s. This is the kind of foolish comment and thinking that probably spooks some investors. We have reminded our clients numerous times over the years that the asset allocation and investment game plan we have in place for each of our clients is a marathon not a sprint. There are always going to be risks, always going to be good/bad economic data and always going to be reports/journalists who make investors feel like the end is near. We ignore most of this and focus on the long term goals and objectives of each of our clients by investing in a well diversified portfolio.

Investing Without Bargains

We are always focused on identifying "fat pitches" in the asset class world. When we find them, in most cases it means a superior return opportunity. At the same time it means we believe we have a significant margin of safety to protect us from the many risks that are always present. Even when there are no bargains, we can generally assess valuations in the various asset classes so we can form an opinion about the degree to which there is (or isn't) a margin of safety. This is how we make prudent investment decisions in an uncertain world.

At an absolute level, there are no fat-pitch opportunities today. Put another way, there are no asset classes priced at levels that make us confident that we are likely to capture big returns over a several-year time horizon. On a relative level there are two areas we continue to be excited about.

Large-Cap Domestic Stocks: From November 1999 through February of this year, large-caps (S&P 500) had a total cumulative return of only 9.6% (1.5% annualized) compared to 72.7% (9% annualized) for small-cap stocks (Russell 2000 Index). **This sizable performance discrepancy leaves large-cap stocks bargain-priced compared to stocks of smaller companies (we began to reduce our small cap exposure 2 years ago and continued to reduce it last year).** Moreover, stocks of larger companies tend to do better when the dollar is weak (their foreign earnings are worth more converted back to dollars and

U.S. exports become more competitive), which is partly why mega-cap stocks are now experiencing stronger earnings growth than smaller companies. They also tend to perform much better than small-caps late in the economic cycle. We may or may not be late in this cycle but we are clearly past the early stage.

A reasonable question to ask is whether large-cap stocks are cheap on an absolute basis, or only a less-pricey segment of an overall market that is expensive. Whether the overall market is expensive is a good question, especially after its very strong second quarter. **Our short answer is that we believe domestic large-caps are reasonably valued and therefore attractive, though not so attractive that we would pound the table over them.**

There is risk to our view. We've just experienced the greatest earnings boom since World War II, thanks partly to profit margins hitting a 40-year high. So the question is: While the stock market looks reasonably valued or even undervalued based on earnings, if profit margins were to move back to "normal" levels wouldn't the overall stock market then be overvalued?

There are really two questions here:

- 1) Are profit margins likely to decline significantly?
- 2) If they do, will stocks be overvalued without a price decline?

It does appear that profit margins are likely to decline in coming years:

- Labor costs are a big part of the equation. They have been the biggest driver of declining margins. The massive growth in the global labor market from China, Eastern Europe, and other parts of the developing world, along with technology-based productivity increases have made it difficult for labor to grab as big a piece of the economic pie. However, labor's lack of leverage may stop deteriorating and gradually reverse, increasing labor costs and putting some pressure on margins. But a big jump in labor costs doesn't seem likely in the foreseeable future.
- Depreciation expense, also a big factor, will also increase given the pick-up in capital investment the last few years.
- Interest expense is beginning to increase because of new borrowing and rising rates.

So, some margin pressure seems likely as the drivers of widening margins lose their momentum. However, it is not clear that margins will suffer a huge decline. Top-line growth has been healthy, and given a very strong global economy, revenue growth could stay reasonably strong. And though productivity is slowing and labor costs may not be as much of a positive, there is still an abundant supply of labor around the world and will be for years to come. China still has a long way to go in its transformation from an agrarian to an industrial economy. So, while we expect profit margins to decline and earnings growth to slow, we are not assuming that the slowdown will be alarming unless there is a recession.

Addressing the general question of the outlook for stocks, there are several other bullish factors. One is the huge volume of money raised by private leveraged buy-out funds. According to investment firm Bridgewater, there is \$300 billion of capital committed to these funds that is yet to be deployed. With the typical levels of leverage (i.e., debt) employed by buyout funds, this could result in almost \$3 trillion of buying power. Over the last few years buyouts as well as corporate share repurchases have removed a sizable amount of stock from the market—about \$1 trillion (net of new and secondary issues) since mid-2004. Though some of that stock may come back into the market as private equity firms exit their investments by taking their privatized holdings public, this trend of sizable amounts of stock disappearing through privatization seems likely to continue for a while and is a bullish factor.

A second factor that is hard to quantify is the growth in sovereign wealth funds. **These are state-run investment funds that invest a portion of a country's currency reserves.** Those countries with excess reserves to invest in this way include China and other developing countries with positive trade balances, as well as many of the oil exporting countries. According to a recent article in *Barron's*, Stephen Jen of Morgan Stanley estimates that these funds may have as much as \$2.5 trillion and are growing rapidly. Their objective is generally to capture higher returns than those offered by government securities (such as U.S. Treasury bonds), which means investing in areas like private and public equities and real estate. China's recent \$3 billion investment in the private equity firm Blackstone Group is an example of this.

Perhaps the biggest risk to longer-term stock returns is inflation and interest rates. The rapid growth in the developing world has caused demand for basic commodities to spike in a big way and is one source of potential inflation. At some point supply is likely to catch up with demand but that point may still be a ways off. However, there is a growing consensus among some of the sharpest fixed-income managers that inflation from a variety of sources is working its way back into the system and that it is likely to move higher in the next cycle (though no one we know of is predicting double-digit 1970s-style inflation).

We haven't seen government bond yields of 6% since they were briefly there in the late 1990s. If we get yields that high or higher in a few years and they stick for a while, investors will require higher expected returns from stocks to justify owning them. Higher returns in that case would require lower prices for stocks relative to their earnings. If we experience an extended period of rising rates it will be an environment that investors haven't experienced since before the early 1980s, when interest rates peaked and began a 20-plus year downward trend. At this point, given the likely continued growth in the global labor force and the potential for productivity strength, a sizable (more than 1 percentage point) and long sustained rise in rates doesn't seem likely but is not something that we can rule out. **A spike in inflation and interest rates is much easier to imagine now than it was a few years ago.**

Getting back to the question of large-cap stocks, what is the bottom line? Based on our analysis, large-cap stocks are a compelling opportunity *relative to* stocks of smaller companies. **Thus, relative to our benchmarks we are still significantly underweight small-caps and overweight large-caps.**

On an absolute basis large-cap stocks are reasonably valued so we are in turn comfortable with the outlook over the next five years, but not optimistic enough to overweight our overall exposure to stocks. Margin compression is a risk but doesn't seem likely to be severe, at least not soon. And even if it is, stocks might still do okay relative to bonds over a five-year period. But, inflation and interest rates are something to watch.

Over the shorter-term, as investors continue to try to read the economic tea leaves in an environment with various cross currents and stresses, we wouldn't be surprised to see some news—economic, financial, geopolitical, a hedge fund or derivative-related blow-up—over the next year that spooks investors and triggers a quick stock market correction. A 10% decline would not be surprising given the performance run since February of 2003 (the S&P 500 has almost doubled). This isn't a prediction but we wouldn't be surprised. If it does happen, we think the downturn is likely to be a short-lived correction rather than the start of a bear market, unless we are heading to a recession, which is possible but seems unlikely given current global economic strength.

New Ideas

One of the fun things about the investment business is that there are always opportunities for new learning and research. One of the areas we have been researching and analyzing for the past year is structured products. In the first half of this year we finally added two different fixed income structures to many client portfolios (NASD rules prohibit us from writing about

these in further detail). We are also in the beginning phases of researching some additional ideas and will be sharing some of those in the future.

—Lido Advisors Investment Team (7/2/2007)

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