

Quarterly Investment Commentary – July 2008

The first half of 2008 dramatically reinforced the idea that over the short term the stock market is predictably unpredictable. A sharply negative first quarter was followed by two months of positive returns, but the sell off resumed with a vengeance in June, with large-cap stocks (as measured by Vanguard's 500 Index Fund) dropping 8.4% for the month and almost 3% in the second quarter. The phrase "June gloom" is used by residents of the Southern California coast to describe the cold and fog that persists this time of year, and it could also be used to describe

investors' moods as the quarter came to an end. The S&P is now down 12% for the first half of this year, and is about 18% below its October 2007 high. The market offered few places to hide. Mid- and smaller-cap stocks fared better than large in the second quarter, but still got slammed in June and now have high single-digit losses for the first half of 2008. Vanguard's Total International Stock Index Fund also had a rough month, losing 9% in June and 2.2% in the second quarter. Foreign stocks are now down 10.9% through the first half once again showing how correlated the world and markets are. REITs were hit hard, dropping almost 11% for the month, putting them in the red for the first half and closer to valuation levels we'd view as attractive relative to stocks (more on this later). Domestic high-quality bonds were flat in June, and down just over 1% for the second quarter. Though not a good return in a normal environment, bonds nevertheless provided balanced investors with a margin of protection from stock-market losses, which is part of their role. The Vanguard Total Bond Market Index Fund, our proxy for the bond market, is up 1.1% through the first half of the year.

What is Driving Stocks Lower Again?

As always happens in an environment of fear, we are being asked (and asking ourselves) a lot of questions. What is going on, and how bad could it get? Is there anything we should be doing about it in our portfolios? This environment is in many ways

June Benchmark Returns (Preliminary)			
	June	2Q	YTD
Large-Cap Benchmarks			
Vanguard 500 Index	-8.4%	-2.8%	-12.0%
Russell 1000 iShares	-8.3%	-1.9%	-11.2%
Russell 1000 Growth iShares	-7.2%	1.2%	-9.1%
Russell 1000 Value iShares	-9.6%	-5.3%	-13.6%
Mid-Cap Benchmarks			
Russell Midcap iShares	-8.0%	2.6%	-7.6%
Russell Midcap Growth iShares	-7.3%	4.6%	-6.9%
Russell Midcap Value iShares	-8.9%	0.0%	-8.6%
Small-Cap Benchmarks			
Russell 2000 iShares	-7.7%	0.6%	-9.4%
Russell 2000 Growth iShares	-6.0%	4.5%	-8.9%
Russell 2000 Value iShares	-9.6%	-3.5%	-9.8%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-9.0%	-2.2%	-10.9%
Vanguard REIT Index	-10.8%	-5.4%	-3.4%
Vanguard Total Bond Mkt Index	0.0%	-1.1%	1.1%
Merrill Lynch High-Yield Bonds	-2.7%	1.8%	-1.2%
Citigroup World Govt. Bond Index	0.4%	-4.2%	5.0%
DJ-AIGCI (Commodity Futures)	9.1%	16.1%	27.2%
JPMorgan ELM I +	0.8%	3.9%	8.7%

unique and presents its own set of challenges, which we'll address more specifically in a moment. **But more generally, we want to start by saying that we've been through a number of crises' over more than a decade of managing portfolios, and while each of these periods presented its own particular challenges, one thing that is common to them all is that a sense of accelerating bad news, escalating risk, fear, and panic were almost always present.**

Looking back to March, the Bear Stearns bailout and the Federal Reserve's unprecedented actions to shore up credit markets and create liquidity led many to hope that we were past the worst of the financial crisis and that the stock market had hit bottom. Today it seems that while the Fed's actions may have significantly reduced the risk and fear of a full-scale financial meltdown, the losses from bad loans are not only continuing, but are continuing to be worse than expected. Meanwhile, the housing market is seeing significant price declines, and with new waves of foreclosures hitting the market and adding to oversupply in many areas, there is no immediate end in sight.

The positive feedback loop of soaring home prices and easy credit is now gone, and with it has gone a major source of consumer spending (which of course is a major driver of the economy). Add in the impacts of high levels of household debt (which suggests the need to retrench rather than spend), higher gas and food prices, a weakening labor market, and, by one measure, consumer confidence at a 28-year low, and it seems increasingly likely that consumer spending will continue to deteriorate. The damaging combination of a slowing economy and higher inflation (the widely feared "stagflation") has also led to questions about the ability of the Fed to support economic growth and employment without stoking fears that it has gone soft on inflation. At their latest meeting in June, the Fed held rates steady (after seven previous rate cuts) and expectations of higher rates later this year has also hurt stock prices. **What it all means is that risks to the economy remain high, and the financial markets are now more fully discounting this risk, which is an unemotional way of describing the battering taken by stocks in recent weeks.**

As always, there are positives as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have been okay. One source of strength has been exports, which so far have managed to offset much of the impact of the housing decline on GDP. But this could diminish if our slowing economy means we also export economic weakness to the rest of the globe, and there are signs that this is happening.

Making Decisions in an Uncertain Environment

"History is merely a list of surprises. It can only prepare us to be surprised yet again." — Kurt Vonnegut

Though we have experienced a multitude of market crises, we also recognize that history never repeats itself exactly, so almost anything can happen from here. One possibility is that things will get worse before they get better in the stock market. **Even without a bad recession, fear and pessimism can take hold of investor psychology and send the market down further than what would be justified by long-term economic fundamentals.**

In this type of environment, a sense of perspective and a reliance on our investment discipline helps us avoid becoming panicked by short-term concerns and paralyzed by longer-term uncertainty. Like it or not, we are always faced with making decisions in an uncertain world and this will not change. However, our experience in past market cycles and our analysis of the current market environment leads us to two important conclusions.

First, as we have written in previous commentaries, we do not believe it is time to get more defensive and reduce our equity exposure. It is easy to put too much weight on negative scenarios when bad news dominates the daily headlines, but we view stocks as priced to outperform bonds over most five-year scenarios.

Second, big market downturns invariably present opportunities, and without them, we would not have had the chance to identify some of the tactical allocations that have added value to our portfolios over the last number of years. Bubbles lead investors to make errors in judgment and mis-price assets on the way up. On the way down, riskier assets often fall to bargain prices when investors are in the grip of fear. Our investment discipline (and our focus on what is knowable) can help us identify those asset classes where investor panic has led to excessive undervaluation. Later in this commentary, we note three asset classes (U.S. equities, REITs, and high-yield bonds) that may be headed in this direction that we are monitoring carefully.

While the perspective gained from years of experience is useful, we are also cognizant of the danger of becoming overconfident. We try to stay intellectually honest about what we can and cannot assess, and we do this by focusing on fundamentals and valuations. Our current assessment of U.S. equities provides a good example of this discipline.

Certainly, the returns on stocks over the last 10 years have been disappointing. **For the 10 years through the end of June, the S&P 500 has compounded at just under 3% annually—a little more than 70 basis points below the annual return on Treasury bills.** So after a 10-year period of far-below-average gains, one might think we are “due” for some strong U.S. equity performance over the next five-plus years. Unfortunately, our analysis does not support such intuition or hope.

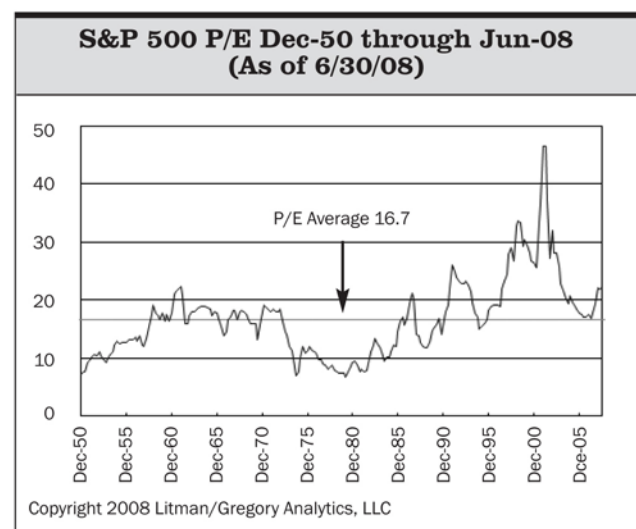
In the decade prior to this one (June 1988 to June 1998), the S&P 500 returned a whopping 18.6% annually. This time span includes an idyllic period for stocks in the mid-'90s during which interest rates fell, the growth rate for corporate earnings climbed above trend, and price/earnings multiples on trailing 12-months earnings expanded from an average in the mid teens to almost 30x. As we all know now in hindsight, investors took their enthusiasm too far in the subsequent bubble period and stocks became overvalued. So in a sense, the low returns of the past 10 years have forced investors to give back some of the excess earned in the previous decade. **When both periods are combined, stocks have returned a little more than 10% annually in the 20 years through June 2008. That's in line with their very long-term average.**

Setting Return Expectations

It would be nice if this history meant that, having come through a decade of above-average returns and a decade of below-average returns, we could now start from scratch and simply expect "average" returns of 10% to 12% a year on equities. Unfortunately, though, the market is forward looking and does not care where it's been; past performance doesn't determine future results. As we look forward to the next five years, our general expectation is for a low-return environment overall—for both stocks and bonds. We note, however, that the market's sell-off in

June has brought equity prices down far enough to make our potential return range on equities higher than it was just a few weeks earlier. Stocks are now priced at levels that are not all that far from the point at which we would tactically overweight U.S. equities.

Given the late-June level of the S&P 500 as well as a range of scenarios we have considered carefully, we believe the most likely range of annualized returns for large-cap U.S. stocks over the next five years is approximately 5% to 9%, though obviously returns could (and probably will) fall outside that range in some 12-month periods. We base our estimates on a multi-year outlook in order to focus on the factors (fundamentals and valuations) that we believe will drive returns over the next market



P/E's remain above their long-term historical average. Our scenarios assume modest declines from current levels.

cycle and to distance ourselves from the day-to-day noise that causes short-term volatility in asset prices.

Our return range is based on the S&P 500 level in late June, and at that level the market appears to be in a fair-value range, meaning that we think it is pricing in a reasonable level of economic weakness. However, as we wrote in our April commentary, a further decline in the S&P 500 could make stocks look attractive enough relative to fixed-income alternatives to justify a tactical overweighting.

As always, there are risks attached to any returns-based fat pitches and one worth mentioning now is the risk that an overweight to equities followed by a continued fall in stock prices could result in our portfolios violating their 12-month loss thresholds. **As mentioned earlier, we would not be surprised if the stock market gets worse before it gets better, and though we believe we can identify a level at which stocks are attractive from a long-term perspective, it's highly unlikely we'll be buying stocks right at the bottom.**

A decision to overweight stocks would become more complicated if we see additional asset classes also become attractive; REITs and high-yield bonds are two timely examples. (See our discussion below.)

Where Does That Leave Us?

Barring a further sell-off in U.S. stocks that makes potential returns look better, single-digit returns for stocks are not very exciting. And bonds don't look very exciting either. Given the current investment-grade bond index yield and current interest rate levels, we see potential bond returns only in the 3% to 5% range, which reflects some ratcheting down of bond prices over the next five years as interest rates move higher.

Given our expectation that stock and bond returns will fall in the low-to-mid single digits, it follows that potential returns for our portfolio will be limited. But we also hope that our ability to identify tactical opportunities will allow us to improve our potential returns. Indeed, we have recently devoted significant time to intensifying our research on REITs and high-yield bonds, two asset classes that are down meaningfully from their highs and that may offer higher return potential in the years ahead. We will also continue to overweight our hedged, opportunistic and non-correlated strategies as it still is our belief that this asset class will generate competitive risk-adjusted returns.

REITs

Our last fat-pitch opportunity in REITs began in 1999 (we held them until March 2004) and the valuation advantages then were obvious. Dividend yields on REITs were around 8%, REIT multiples were at their lowest-ever level relative to the S&P 500, and REIT stocks were selling at a modest discount to the value of the underlying property they

owned. Meanwhile, the S&P 500 was rocketing to new highs and the dividend yield on that index fell below 2%. The downside for REITs versus the S&P 500 seemed limited and the yield advantage was significant.

Fast forward to today and the advantages that REITs offer are not so obvious when analyzed using only historical valuation measures. If we judged REIT valuations solely relative to historical valuations, most metrics suggest that they do not look attractive on an absolute basis. However, REITs today may actually be attractively valued if judged based on their return potential versus U.S. equities and investment-grade bonds. On top of a roughly 5% dividend yield (which is historically on the low side), if we also make a conservative assumption for additional return generated by cash-flow growth, plus the value that active REIT managers can add through property management as well as through their use of leverage, we think potential returns on REITs are at least competitive with and perhaps better than U.S. equities.

We are aware of potential risks with REITs. One risk is that further economic weakness could lead to deterioration in REIT fundamentals. Another is that an extended period of more stringent and costly financing could cause further declines in property values, at least temporarily. In either case, our analysis suggests that REIT share prices are already discounting a significant level of risk. The impact of higher interest rates on REITs is another scenario we are examining and, along with that, the consequences of higher rates on the relative performance of competing asset classes such as U.S. equities and bonds. We have not come to a conclusion yet, or identified a specific trigger point on REITs, and this is complicated because equity valuations are a moving target as well. But we can report that we are approaching a point at which we would view REITs as a fat-pitch opportunity.

High-Yield Bonds

We are also monitoring high-yield bonds closely as we believe a tactical opportunity could be created at some point during this economic cycle (and it is possible this could happen soon). **Yields on high-yield bonds have risen to just under 11% from their recent lows of 7%. Currently, that represents an almost 700-basis-point spread over 10-year Treasuries, which is about two percentage points above the long-term average.**

But while the valuation picture has improved, there are two main reasons why we do not see high-yield as meriting a fat-pitch allocation at current levels. First, while yields and spreads on junk bonds have increased, they do not, in our view, adequately compensate investors for economic or sector-specific risk. **Second, key drivers of high-yield bond total returns are the default and recovery rates, and there are troubling indicators signaling a potential increase in the former and a decrease in the latter.** Defaults are forecasted to increase to 6% to 7% in the coming year but in the past, they have risen as high as 10% to 11% during periods of economic stress. (The long-term

average for defaults is a little less than 4%.) One leading indicator of default rates is the distress ratio (the percentage of bonds yielding 1,000 basis points over Treasuries) and this ratio has accelerated sharply from lows in the summer of 2007. If it continues to rise, it would raise concerns about an even greater acceleration in default rates.

For bonds that default, the recovery rate measures the percentage of the bond's value that is recouped after the default. The long-term average for recovery rates on defaulted bonds is 40% but it tends to be lower (closer to 30%) during periods of higher defaults. By our estimates, we believe higher defaults would likely detract at least two percentage points of total return, and potentially quite a bit more in a bearish scenario. As mentioned earlier, we are also analyzing the impact of a potential increase in interest rates on potential returns. Such an increase could lead to a capital loss on high-yield bonds over a 12-month time period and this too plays a role in the scenarios we are currently analyzing. In short, we see a number of risks in this asset class but we also see an improving valuation picture, and if conditions improve enough, we may conclude that potential returns on high-yield bonds are superior to the returns we expect from a mix of U.S. equities and investment-grade bonds.

One important consideration for both high-yield bonds and REITs is the impact of taxes on potential returns. With asset classes where a significant portion of total return stems from income and dividends, the pre-tax and after-tax returns can be quite different. This is something we will keep in mind as we evaluate whether a fat-pitch opportunity in either asset class exists.

The Road Ahead

As we have said in our recent commentaries, this is one of the most challenging investment environments we have ever faced. We expect this to continue to be the case, at least for a while. Given our expectation of low returns in the mainstream asset classes, we are not only assessing fat-pitch opportunities, but we are searching for new opportunistic / absolute return investments as well as structured products.

Despite our expectations for a challenging, lower-return environment, we believe we can add value from both our tactical asset allocation and manager selection decisions. In terms of our current portfolios, we think our overweighting of large-cap stocks relative to small-cap stocks remains warranted and will add value in the long term. Many of the fund managers we respect most tell us they are buying shares of high-quality companies at bargain-basement prices. **Consequently, even though the overall market does not look compelling to us from a top-down valuation perspective, the current economic and market turmoil appears to be creating significant return opportunities at the bottom-up individual stock level.** Indeed, it is often when the overall trend is negative that disciplined investors can build a portfolio for long-term out performance by carefully taking advantage of the opportunities created by these

dislocations. It requires patience and the ability to weight long-term analysis above short-term fear, but it is what distinguishes successful investors.

—The Lido Advisors Research Team (7/7/2008)

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