

## Quarterly Investment Commentary | October 2006

Returns were generally good in the third quarter for most asset classes. Some stock indexes are finally reaching record levels first touched over six years ago (though the NASDAQ remains far below its peak). The larger-cap S&P 500 index ended up 5.6% for the quarter. Small caps were nearly flat, gaining 0.4%. Value outpaced growth across all market caps. Other asset classes were also positive for the quarter: domestic investment-grade bonds and international stocks were each up about 4%, while short-term emerging-markets bonds gained almost 3%. Commodity futures had the worst quarter by far, losing 6.5%.

### Review of Equity Valuations

With oil prices dropping and the Fed finally pausing after a lengthy string of rate hikes, the markets have had a nice run in the past few months. **From its most recent bottom in mid-July, the S&P 500 is up almost 9%.** Normally a rising stock market makes stocks more expensive, but earnings (helped by a reduction in the supply of stock) have also been positive over this stretch. **Investors who buy a share of stock are really buying a share of a company's future earnings, and rising earnings have kept the valuation picture from changing as much as one might think.** The Fed's often-cited valuation model—which compares the consensus 12-month forward operating earnings estimate for the S&P to the current 10-year Treasury yield—suggests an undervaluation of more than 30%. Several other approaches we use tell a similar story; the degree of undervaluation varies quite a bit from one method to another, **but even the more conservative of these valuation methods suggest the market is at worst in a fair-value range.** (This is not to say that all experts believe the market is undervalued—some do not—but they generally use quite different valuation methods in which we have less confidence.)

Why do stocks measure as being cheap right now? The stock market (or more accurately, the collective opinion it represents) seems to believe that a significant economic downturn is likely enough that it is pricing stocks based on a potentially big decline in earnings. How big? When we walk through the math, it shows that earnings would have to decline by a historically large amount in order to validate current stock prices. As an example, normalized earnings would need to drop by almost 25% to show stocks as being fairly valued; since 1950, there have only been one or two instances where earnings moved that much from peak to trough. Over rolling five-year periods, it has also been very unusual for nominal earnings to show average declines of more than a couple percent per year annualized. There are many factors that could contribute to declining earnings going forward—a housing-induced recession, under funded

| September Benchmark Returns (Preliminary) |       |       |
|---|-------|-------|
|   | Sept. | YTD   |
| <b>Large-Cap Benchmarks</b>               |       |       |
| Vanguard 500 Index                        | 2.6%  | 8.4%  |
| Russell 1000 Growth iShares               | 2.7%  | 2.8%  |
| Russell 1000 Value iShares                | 2.0%  | 13.0% |
| <b>Mid-Cap Benchmarks</b>                 |       |       |
| Russell Midcap iShares                    | 1.8%  | 6.9%  |
| Russell Midcap Growth iShares             | 2.3%  | 3.3%  |
| Russell Midcap Value iShares              | 1.3%  | 10.6% |
| <b>Small-Cap Benchmarks</b>               |       |       |
| Russell 2000 iShares                      | 0.8%  | 8.6%  |
| Russell 2000 Growth iShares               | 0.7%  | 4.1%  |
| Russell 2000 Value iShares                | 1.0%  | 13.0% |
| <b>Other Benchmarks</b>                   |       |       |
| Vanguard Total Intl Stock Index           | 0.2%  | 13.9% |
| Vanguard REIT Index                       | 1.9%  | 23.8% |
| Vanguard Total Bond Mkt Index             | 0.8%  | 2.9%  |
| Merrill Lynch High-Yield Bonds            | 1.3%  | 7.2%  |
| Salomon Brothers World Govt Bond          | -0.3% | 4.2%  |
| DJ-AIGCI (Commodity Futures)              | -6.0% | -3.2% |
| JPMorgan ELMI +                           | -0.4% | 5.3%  |

employee liabilities such as pensions and health insurance, and even a simple reversion to normal profit margins—but it's really only a perfect storm that would cause earnings to drop so much and/or over so prolonged a period that it would justify current valuations.

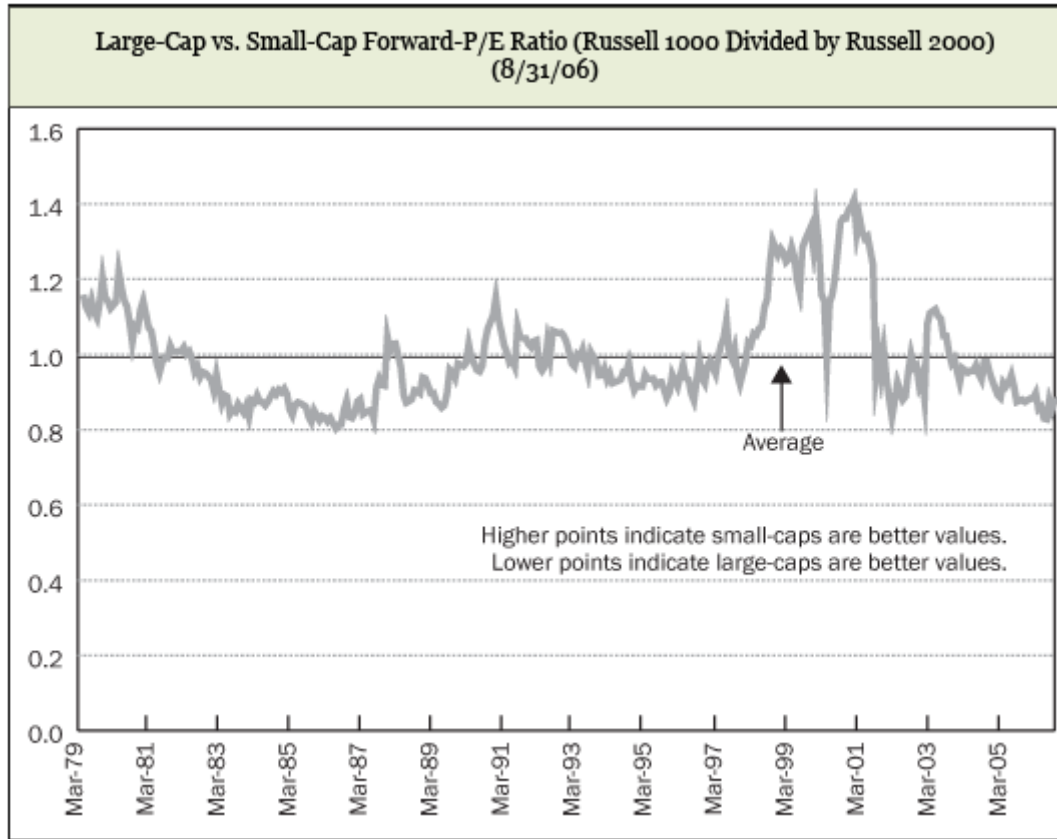
The stock market is not always right (we are reminded of the quip about the market having predicted nine of the last five recessions) and if it is wrong then stocks really are undervalued. **But, in our view, broad risk levels are higher than average right now, and we are no different from the rest of the market in that these risks impact our enthusiasm for stocks.** In addition to the above-mentioned factors, there remain problems associated with our current account and federal budget deficits, the looming threats of Social Security and Medicare liabilities, high levels of consumer debt, the growing—and potentially large—amount of unregulated private lending and derivative use that has evolved along with the growth of hedge funds and other similar entities, and the continuing risk of an economically damaging terrorist attack. **These bigger-picture risks are on top of normal cyclical risk;** with the economy slowing and the housing market deteriorating rapidly, recession risk has risen. These risks are material enough to make us more cautious than we otherwise would be in deciding whether to overweight equities.

On the positive side, it is entirely possible that the U.S. economy will have a soft landing and continue to expand for several years, and we are always pleased when stocks are priced with a big valuation cushion, since this reduces our downside risk (most bear markets, for example, start from a point of high or excessive valuation). As long as stock prices are factoring in a higher risk premium, stocks will continue to look undervalued relative to valuation comparisons over the past 25 years. However, if investors' risk perceptions improve, the resulting higher valuations would drive a return spike (all other things being equal).

Among other equity asset classes, foreign stock valuations are now in line with their historical average relative to the U.S., but we remain slightly over weighted to our International managers because we still believe there are more opportunities overseas. Among domestic equities, growth stocks look slightly cheap relative to value stocks on a statistical basis, an opinion which has also been voiced by many of the managers we respect. We over weighted growth stocks in December 2005 and it appears as if our overweight was premature as value has continued to dominate growth this year. This is the primary reason why our domestic equity allocation has underperformed the market (S&P 500) in 2006, but we are confident growth will outperform value over the next investment cycle.

## **Explanation of Our Smaller-Cap Reduction**

Last month we reduced the small-cap exposure in some of our portfolios and moved the proceeds into large-caps, opportunistic funds and in more conservative portfolios short term bonds. We are going to continue to reduce our small cap allocation once we complete our due diligence on some new investment opportunities. **In reaching this decision, we looked at data from several sources, and in every case these metrics showed small-cap valuations at or near the high end of their historical range relative to large-caps.** The chart below shows the historical relationship between large-cap and small-cap P/E ratios. A ratio of ratios may be difficult to get one's arms around, but it's worth understanding. A P/E ratio on its own tells us how much it costs to buy a dollar of earnings: a higher P/E ratio means you are paying a higher price for that dollar, and a lower P/E ratio means you are paying a lower price. This chart is nothing more than a way of comparing the "costliness" of large-caps and small-caps relative to one another based on their P/Es. Right now, this data shows that small-caps are expensive relative to large-caps. In fact, they are nearly as expensive as they've ever been, an observation supported by other data sources as well.



We also believe that cyclical considerations favor a lower small-cap weighting. We're well into the economic cycle, and small-caps' best periods of relative performance typically come early in the cycle. Another cyclical argument comes from the Leuthold Group, which states that since 1950, periods of small-cap outperformance have lasted an average of 70 months. The current cycle has been going for 87 months (as of June 2006), so we're well beyond the average, although still well short of the run that small-caps had in the 1970s and early 80s, which lasted roughly 120 months (10 years). **Neither of these observations alone would cause us to make a move, but when combined with the valuation backdrop, we think the odds are very good that large-caps will beat small-caps on average over the next five years.**

We want to emphasize that our basis for underweighting smaller caps is relative. Our analysis leads us to believe that one asset class (large-caps) will do materially better than another (small-caps), but this could play out in several different ways. For example, we could have a short bear market, where larger-caps go down, but smaller-caps go down a lot more. Or we could have an extended period of mediocre or weak earnings growth, where larger-caps generate average gains in the mid to upper single digits, while smaller-caps return close to zero. Based on our analysis, we think that on average over the next several years, assuming no recession, larger-caps could generate decent returns—perhaps even in the low teens—which implies that smaller-caps would probably still put up positive numbers. **The point we're emphasizing is that larger-caps are not currently a compelling absolute return opportunity on their own, but rather that smaller-caps are clearly unattractive versus larger-caps, and as such we want to shift our asset allocation accordingly.** Our overall equity exposure remains unchanged.

As we require of any tactical (fat-pitch) portfolio move, our conviction level is very high that this decision will pay off over a sufficiently long time frame (somewhere in the five-year

range). But it is worth a reminder that we can't say with confidence how larger- and smaller-caps are likely to perform relative to one another in the near term. History is full of examples where an asset class stayed overvalued for years at a time, then took years to return to a normal valuation level. While we can use history as a guide in forming our expectations, there is no way to know for sure how long it will take for this move to pay off. Smaller-caps could already be on their way down, or they could continue to outperform larger-caps for a few more years (if the current economic expansion continues for several more years, which is a real possibility), and in that scenario it's probable that we'd shift even more money out of smaller-caps as the valuation disparity widened.

## The Economy and Bonds

The Federal Reserve has finally put on hold the string of interest rate hikes that began more than two years ago. **Over this time period, the Federal Funds rate climbed from 1% to 5.25%, making it one of the sharpest tightening cycles on record.** Decelerating earnings growth, a slowdown in the housing market, and a drop in oil prices, among many other factors, all undoubtedly contributed to the Fed's decision to hold off on further hikes. Among the sources we look at, there is a growing consensus that the economy is slowing down, but there remains a wide range of opinions as to what happens next.

Some bears argue that the decline in housing prices will have a material effect on the economy: a negative wealth effect will cause consumers to cut back on spending, and the construction and financial industries that experienced job growth during the housing boom will turn the other way as that boom reverses. Combined, they argue, these factors will result in a meaningful recession.

The bulls, meanwhile, argue that corporate America is in great shape, and that even if housing takes a nosedive, the data does not support a meaningful contagion effect throughout the broad economy. The fact that there is disagreement even within particular firms—including PIMCO and FPA's fixed-income team—**reinforces our belief that economic forecasting is a notoriously tricky process.**

Where does that leave us? In short, we agree that the risk of recession is greater today than in recent years. This view is bolstered by the fact that the current economic expansion has lasted 60 months, compared to a post-war average of 55 months. Of course, this is just an average, and there have been expansions—such as the one throughout most of the 1990s—that lasted roughly nine years. We believe it's largely impossible to predict with consistent accuracy when a recession will occur, but the longer we go without one, the closer we are to the next one. For us, that means we need to manage our portfolios with an eye towards this risk, as well as others. Balancing the potential downside of negative scenarios with the potential upside of positive scenarios, then wrapping it all in the context of valuations, has always been the key to how we make portfolio decisions. High-quality bonds are generally the best-performing asset class during recessions, and as such we believe bonds still have an important role to play in balanced portfolios (bonds help mute the volatility of equities in other scenarios as well). **The bottom line is that we don't need to be able to forecast the economy with precision in order to make sound portfolio decisions.**

## Foreign Bonds

At almost 6% of GDP, the U.S. current account deficit remains near its worst level in history. The only way that one can realistically expect this imbalance to continue is to assume overseas investors will continue to invest in the U.S., either through purchases of securities, such as stock and bonds, or through direct investment in projects and businesses. **An argument can be made that the U.S. is one of the best places to invest, an argument supported by the fact that foreign holdings of U.S. stocks and bonds are at all-time highs.** Overseas governments have been big buyers of Treasury bonds, which has helped

keep interest rates down, which in turn has helped keep our economy humming along. But as our assets become a larger and larger percentage of foreigners' portfolios (making them less diversified) the odds become greater that they will slow or stop their buying. There are also other reasons why, over time, foreign investors are likely to become less willing to invest so heavily in the U.S. One scenario is that as some of these countries develop and increase their own consumption, their reliance on U.S. consumers could decline somewhat, making exports to the U.S. less important to their economy. And at the same time they may begin to divert more of their capital to the investment opportunities in their own, more rapidly growing economies.

Foreigners' demand for our financial assets has, to some degree, offset our demand for their goods and services, and that has mitigated the dollar's decline over the last several years. The dollar did decline a significant amount between 2002 and 2004 against a basket of major currencies, so a partial correction of this imbalance has started, but the dollar has declined far less relative to "other important trading partners," a group defined by the Fed that includes China, Mexico, and much of Latin American and Asian emerging markets. The fact that the current-account deficit, which is mostly driven by our trade deficit, remains at an all-time high is further validation that the dollar's declines thus far have been insufficient to correct this imbalance. To us, this suggests that on a long-term basis, the dollar is likely to experience further declines. **This is the most important argument underlying our position in emerging-market short-term local-currency bonds. These bonds have higher yields than U.S. bonds of similar maturity, which is an additional argument in their favor, along with the improving fundamentals in many emerging-market countries.**

Having said that, this investment is not a perfect hedge in the event of a sharp and disorderly decline in the dollar. In that scenario, emerging market currencies could come under selling pressure because of their closer ties to the dollar and a broad move away from riskier economies. Developed-market foreign bonds could certainly do better in that situation, but are considerably less attractive in a base-case scenario for several reasons: their lower nominal yields; the fact that most of their currencies, with the exception of the yen, have already had big moves versus the dollar; and that as a group they don't represent some of the countries with which our largest trade imbalances exist. It's a difficult balancing act, but we continue to believe that emerging-market short-term local-currency bonds provide valuable diversification and the potential for very good long-term returns relative to domestic bonds.

## Commodity Futures

The last several months have been a reminder that commodity futures are a volatile asset class. **Given that spot oil prices have declined from a peak of almost \$80 per barrel earlier this year to just under \$65 as of this writing, and that natural-gas prices have plummeted approximately 70% in 2006, it's not at all surprising that commodity futures have declined recently as well.** Our tactical criteria for owning this asset class are not yet telling us that it's time to sell, although if the Fed decides to cut rates sometime in the next year our view would likely change. In the meantime, we continue to believe that this asset class has significantly positive characteristics that make it worth owning, including: (1) the "risk premium" earned for absorbing shorter-term price volatility, (2) the added return over time from rebalancing the components of the commodity-futures index each year, (3) the return on the collateral backing the futures investment, and (4) its diversification benefits when mixed with stocks and bonds.

## Conclusion

We are pleased that there are tactical opportunities in short-term emerging markets bonds, commodity futures, and larger-caps versus smaller-caps in our portfolios. We are confident these moves will modestly improve our return prospects while helping mitigate certain risks over coming years. That said, there are still no compelling, purely return-based opportunities at this time. The fact that several of our managers have trailed their benchmarks at the same

time hasn't helped, and as a result our performance has lagged this year after a long stretch of outperformance. The shorter-term underperformance of our managers does not impact our confidence in their ability to beat their benchmarks over the long term. Over the years we have often observed and commented that even top managers occasionally have lengthy and sometimes significant stretches of underperformance. The managers we use are chosen based on extensive due diligence, and we follow up with them frequently. As long as our original thesis remains intact, and there are no material issues that impact our confidence in their investment edge, we know that underperformance is not by itself a reason to make a change. **Even the greatest managers will at times test their investors' patience, but as in all investing, patience and discipline are keys.** At the asset class level, we will remain patient as well, and when the inevitable mispricing provides us with a compelling return opportunity, we will be ready to take advantage of it.

## Lido Advisors Investment Team (10/2/2006)

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