

Quarterly Investment Commentary /October 2007

The market volatility, credit crunch, housing market collapse, and hedge fund debacles make it hard to believe the overall stock market was in the black during the third quarter. **But it was, with the S&P 500 gaining a little over 2%.** Moreover, through September the index is up 9.13% on the year. While the numbers for the overall stock market were quite satisfactory over both periods, there was a wide degree of variation across asset classes. Value benchmarks were in the red for the quarter, with smaller-caps doing worse. Growth benchmarks did quite a bit better, with larger-cap growth stocks generally delivering strong returns during the quarter. **For the year growth is ahead of value by a wide margin after seven consecutive years of underperformance.** International stocks gained over 4% in the quarter, extending their run of impressive returns. With the exception of high-yield bonds most other fixed-income asset classes had a solid quarter, with investment-grade bonds climbing almost 3%, emerging-market short-term bonds returning almost 5%, and commodity futures gaining over 6%. REITs managed to post a positive quarter with a return of 2.4% though they are still in the red on the year.

September Benchmark Returns (Preliminary)		
	Sept	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	3.7%	9.1%
Russell 1000 Growth iShares	4.2%	12.5%
Russell 1000 Value iShares	3.4%	5.9%
Mid-Cap Benchmarks		
Russell Midcap iShares	3.3%	9.3%
Russell Midcap Growth iShares	3.9%	13.2%
Russell Midcap Value iShares	2.5%	4.7%
Small-Cap Benchmarks		
Russell 2000 iShares	1.7%	3.3%
Russell 2000 Growth iShares	2.9%	9.2%
Russell 2000 Value iShares	0.4%	-2.8%
Other Benchmarks		
Vanguard Total Intl Stock Index	6.4%	17.0%
Vanguard REIT Index	4.3%	-4.1%
Vanguard Total Bond Mkt Index	0.7%	3.7%
Merrill Lynch High-Yield Bonds	2.4%	3.4%
Salomon Brothers World Govt. Bond	2.5%	6.8%
DJ-AIGCI (Commodity Futures)	8.0%	11.0%
JPMorgan ELM I +	4.0%	11.1%

“Prediction is Very Difficult, Especially of the Future”

The above quote is credited to physicist Neils Bohr, and it comes to mind in assessing the developments of the turbulent third quarter and what they may mean for investors.

The Economy—In the realm of economics and investing it is easy to find plenty of intelligent-sounding predictions about the future. Investors are drawn to forecasts about the economy and the markets because they make investment decisions much easier. **Unfortunately, accurately predicting the future is another story.** The real key is to accept that some things are inherently uncertain and instead focus on the knowable. The trick is then to balance the two in assessing a range of possible outcomes.

When it comes to assessing possible scenarios, it would be immensely helpful to accurately predict the health of the economy. **One thing we know is that credit is the lifeblood of the economy and it has become less available than it was.** The ability of homebuyers to easily access capital without having to prove their creditworthiness will go down as one of the defining characteristics of the last few years, as it contributed to an unprecedented surge in housing prices in many parts of the country. At the same time, in the leveraged buyout

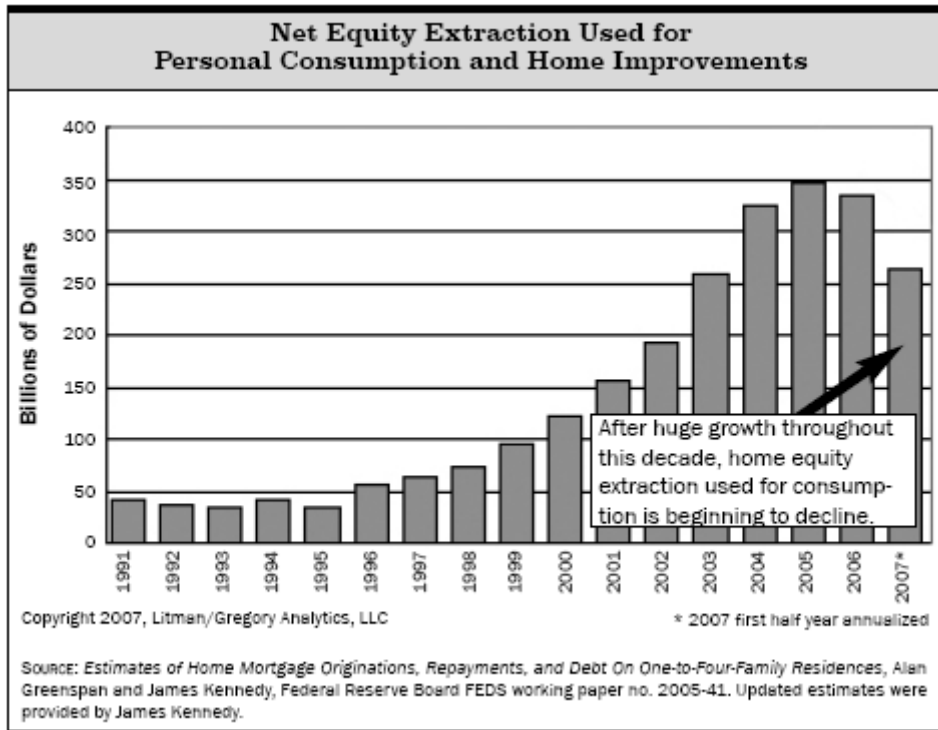
market, loans were written on remarkably generous terms, which spurred acquisitions at ever increasing cash-flow multiples and boosted stock prices.

Unfortunately, when excesses end, things don't just return to "normal." Often they go to excess in the other direction. This type of snapback triggered much of the volatility during the third quarter as there was an extreme lack of interest in holding consumer-backed debt, and an inclination on the part of most institutions not to lend to each other. This cascaded into broader risk avoidance on the part of investors, hedge funds, and other financial market players who had played an important role in expanding the amount of available credit. This was greatly exacerbated by large amounts of leverage (debt) held by many of the non-bank credit providers (e.g., hedge funds). The result was that credit, which as noted is crucial to the economy, was sharply restricted for a few weeks. **With the Fed's decisive action in September to cut the federal funds rate by 50 basis points things have settled down but they have not returned to normal.** Capital will no longer be available to certain groups of borrowers and it will be costlier to other groups. This we can count on and it's not a bad thing, because excess liquidity was leading many investors to make imprudent investment decisions. What is bad is a seizing up of the credit markets in a credit-dependent economy. It seems highly probable that the economy will, at the very least, experience slower growth.

The question now is how long it will take to fully return to a normal credit environment, which is necessary to mitigate recession risk. If there are other events that shock the markets and cause another retrenching, recession risk will rise further. Because there is a lot of credit extended through hedge funds (which lend their capital) and structured products (e.g., collateralized debt obligations which slice and dice loan portfolios to create different risk tranches that are then repackaged and sold to investors) it is difficult to know the magnitude of some of the more questionable debts, who holds them, and whether they are in strong or weak hands. This in turn makes it hard to know if there may be blow-ups yet to come.

While the credit markets are better than they were but still not back to normal, the other problem—also making daily headlines—is the housing market. The housing market is loaded down by months of excess inventory, while at the same time the downfall of the subprime lending market and the tightening up of the rest of the mortgage market has led to a negative feedback loop. The problems result in fewer and more-cautious buyers, which makes for softening prices, which keeps lenders cautious, which makes for fewer buyers, which softens prices, and so on.

With the housing ATM machine largely shut down and home sales severely slumping, the economy is faced with the possibility of a material cutback in consumer spending—the primary driver of economic growth. Consumers have less cash available, there are fewer homebuyers buying things for their new home, and the homebuilding and mortgage industries are retrenching. All this has a negative multiplier effect on the economy. A key going forward will be the labor market, which, while still pretty healthy, has begun to exhibit a few signs of weakness over the past few months, starting even before the summer meltdown.



The problems seem bleak, but as always there are additional factors to consider.

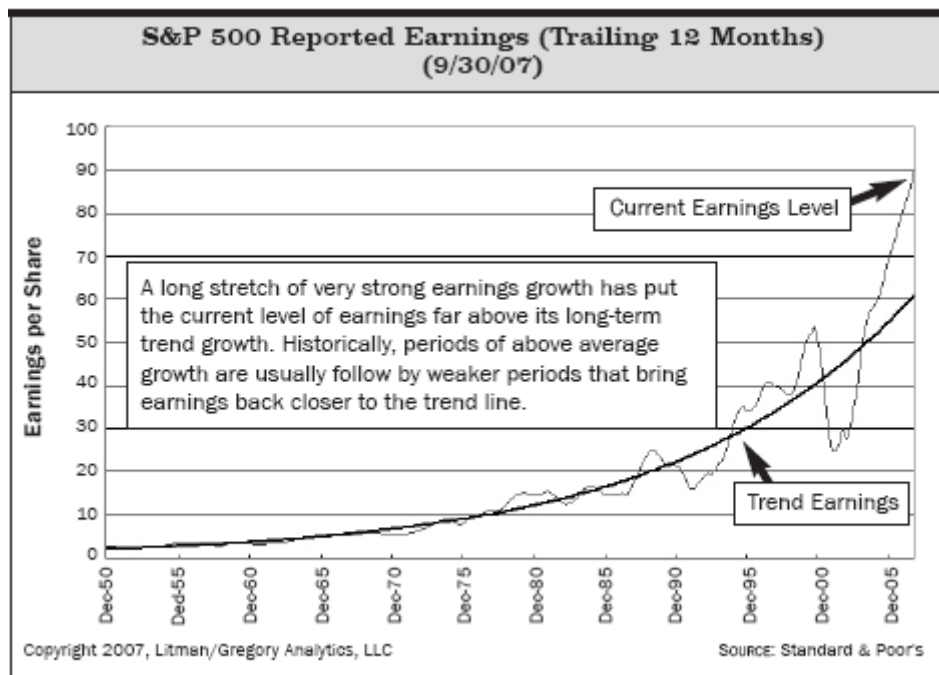
- The global economy has been quite strong and is less dependent on the U.S. than it used to be. For example, according to Goldman Sachs, the four largest emerging market economies—Brazil, Russia, India, and China—are responsible for a sizable portion of the growth in global demand and significantly more than the U.S. In general, due to much-improved economic fundamentals, the emerging markets are playing a much more important role in the global economy. On the other hand, the credit crunch is being felt around the world, not just in the U.S. Europe, in particular, is sharing the U.S.'s experience and in several countries there are similar problems in the housing market.
- The weakness in the dollar, as long as it doesn't turn into a rout, is like an interest rate cut. It will help U.S. export growth, which has already been very healthy, and contribute to the bottom line of U.S. firms that do business globally. **Meanwhile, a dollar collapse is unlikely because this outcome would be very harmful to the global economy. For this reason central banks around the world would take extreme measures to avoid it.**
- The Fed does have influence and room to maneuver. If the economy continues to weaken, the Fed can be expected to continue to lower short-term interest rates to make more capital available at a lower cost, which should spur the economy. But the financial markets are expecting additional rate cuts, so if the Fed doesn't lower rates this year, market participants are likely to react negatively. Also, additional Fed rate cuts (along with a declining dollar) may spur increasing inflation expectations, which would not be a positive for the economy or longer-duration interest rates.

The bottom line is that the economic outlook is murky. Due to the credit crunch and continued deterioration in the housing market, recession is more likely than it was earlier in the year. But it is not a foregone conclusion. The few firms whose economic forecasting we respect (which doesn't mean they are always right or that we make decisions based on their forecasts)

continue to believe that a recession is not the most likely outcome, but most are less confident than they were a few months ago.

Valuations—When it comes to focusing on the knowable, we find comfort in our ability to assess asset-class valuations. Valuation analysis gives us a way to gauge how much risk is reflected in the price of an asset class. We agree with Bill Miller (and others) who say the key question in investing is always, “What is being discounted in the current price?” Conceptually speaking, when assets are cheap a lot of bad things are already taken into account in the price. If these bad things don’t happen, prices should rise sharply as investors realize that they were over-discounting the risks. If the risks do come to pass, the asset price already largely reflects them. When assets are expensive the reverse is true. While valuations are part math and part art, we have a framework to help us assess valuations and also how confident we should be in the analysis at any point in time.

With respect to larger-cap stocks (which make up most of the stock market), all of our earnings-based valuation work suggests stocks are somewhere between reasonably valued and cheap. However, the analysis is not this simple. The concern is that profit margins have been rising steadily over the past three years and are at unusually high levels, which has led to surprisingly strong earnings growth, way above the long-term earnings-growth trend of 6% to 7% annually in nominal terms. In the past, when earnings have jumped ahead of the trend, they have followed with a period of subpar growth. If we assume earnings are back on trend in five years, that we have a recession at some point during that period, and that the market is fairly valued at the end of five years, annualized returns from here are likely to be in a subpar range—perhaps somewhere between 3% and 7% (including dividends), depending on the valuation methodology and assumptions we use. If earnings do better, returns should be higher.



What This All Means—This may sound like a broken record but it bears repeating and we will continue to repeat it in the years to come. **We are constantly making decisions in an uncertain world.** Economic predictions are not accurate enough to serve as a basis for investment decisions. We are more confident in our valuation work as a basis for decisions, but this can not be done in a vacuum. So what do we do?

We know the economy could fall into recession. But it could also avoid recession and surprise on the upside with the aid of Fed easing, a weaker dollar that stimulates exports, and global growth driven by emerging markets. Getting defensive could result in missing out on returns that could be captured during, potentially, a few more years of economic growth. **(It's worth noting that many of the "experts" arguing for a defensive posture now have been bearish on equities for many years and missed the strong global equity market rebound since 2003.)** On the other hand stocks could drop 10% to 20% in a cyclical bear market.

So what we do first is draw on our basic building blocks of portfolio diversification.

- Our allocation and overweight to the "hedged / alternative" category has produced returns superior to bonds (Lehman Brothers Aggregate Bond Index) with risk (standard deviation) much less than stocks. We are continually looking for new, unique and opportunistic managers and will continue to overweight this asset class for the foreseeable future.
- More generally, we have a historical and common-sense framework to understand how asset classes perform in a variety of economic and market environments, including in cyclical bear markets.
- Moreover, that framework allows us to understand what factors drive the performance of each asset class from one cycle to another (liquidity and interest rates, starting valuations, earnings). Not every cycle is the same.

Second, we factor in our valuation analysis for each asset class. At this point in time the major asset classes are in neutral territory—neither very attractive nor unattractive on a long-term valuation basis. However, we did reduce our small cap allocation over the past 2 years and significantly increased our weighting to large cap growth and International equities last December, which is adding a tremendous amount of value so far this year.

Third, we identify risk parameters for each portfolio. This allows us to accept a certain amount of near-term risk (one-year loss thresholds) in exchange for some flexibility to capture long-term return.

This approach allows us to capture long-term returns driven by factors we have the most confidence in (valuations), while still keeping risk in line with each portfolio's profile.

This process today leaves us right where we have been. For quite some time we've believed most equity asset classes to be in a fairly priced range—suggesting that over the long run we will make more money there than we would in more defensive asset classes (bonds). We've been rewarded for taking that view, but we have also recognized that, as always, there are troubling risks. Our analysis supports a continued balance between equity return opportunity and hedging of risks so we will continue to maintain a middle ground. However, as the economic expansion continues to mature we will reassess the degree to which we want to hedge against the possibility of recession.

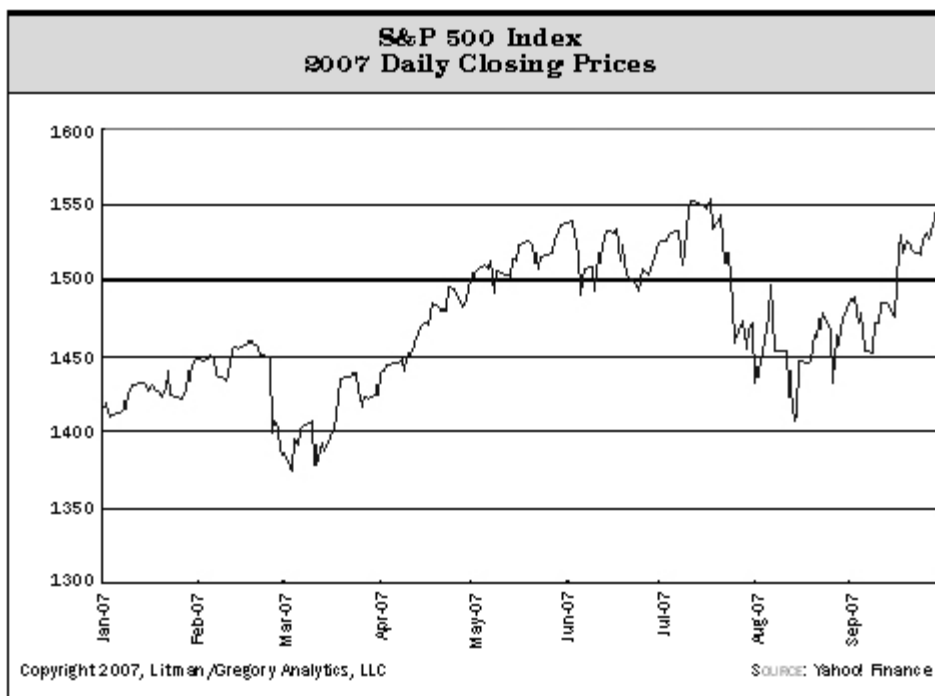
Reminders, Observations, and Lessons

There are lessons to be learned and observations to be made from every market event. The events of this summer were significant, and bring to mind several valuable reminders.

Market declines are common and don't always lead to bear markets: According to Ned Davis Research, Inc., there have been 262 instances since 1928 in which the S&P 500 dropped at least 5% but did not drop as much as 10%. When the market has dropped at least 5%, only 33% of the time has it ultimately dropped more than 10%. There have been 87 other instances when the market dropped 10% but not as much as 15%. When the market has

dropped 10%, 44% of the time the loss reached at least 15%. Regardless of how far any market decline goes, investors are always nervous during the decline and headlines are usually disturbing as the risks become the central focus. **But more often than not, when the market declines are in the single-digits, it doesn't turn into a double-digit decline.**

Trying to react and time markets often leads to whipsaw: Investors often react to market declines and scary headlines by becoming more risk-averse, extrapolating their worries without thinking about possible offsetting factors or the potential for sudden shifts in market psychology. For example, during the third-quarter market decline, the markets improved largely thanks to Fed action. (The market was clearly not discounting a 50 basis point rate cut.) **Between July 19 and August 15 the S&P 500 declined over 9%. By September 19 stocks had recouped most of the decline. When markets are volatile, sentiment can shift quickly—it takes a lot of good luck to add value through timing. And you have to get lucky twice: When to get out of the market and when to get back in. Counting on luck is gambling, not investing.**



Selling into weakness frequently resulted in missing out on quick rebounds.

Excesses always end badly: We've seen this many times before ... betting on things that don't make sense does not pay in the long run. Investing in real estate during the 1980s based only on tax benefits turned out to be very costly. Buying Internet stocks that had no earnings and not much of a business plan was a disaster. And investing in loans that had virtually no underwriting standards—no money down or income verification—was an accident waiting to happen. **Investment discipline based on common sense can sometimes test an investor's patience when common sense is temporarily ignored (e.g. the Internet stock bubble in the late 1990s), but it always pays off in the end.**

There are certain return relationships between asset classes that generally hold, but basing a portfolio strategy on the assumption that they will always hold can lead to mistakes: We all like to have general rules we can apply. But the world is not this simple. For example, in stock market declines, REITs tend to outperform equities and value stocks tend to outperform growth but the context of each period can lead to different results. In the recent market decline REITs, which were already in a bear market, following a huge multi-year bull

market—fell more than the overall stock market. Value stocks fell more than growth stocks after a similarly long stretch of value outperformance as investors worried about earnings. By factoring in the prior market performance, valuations, and the market cycle, it was possible to add value beyond just relying on rules of thumb.

Final Thoughts

With three-quarters of the year in the books, returns have been pretty good—not fantastic but not bad either. But somehow it doesn't feel that way. So far each of our asset allocation plays has added value in 2007, with emerging-market short-term bonds, fixed income structures, the hedged/alternative category and large-caps (we are overweighted versus small-caps) all outperforming the asset-class alternatives that we would have otherwise owned.

Looking ahead, there are a number of positives for the financial markets, including relatively low interest rates and a surplus of global liquidity looking for a good return. However, the driving factor for returns over the next year will likely be the U.S. economy and its impact on the rest of the world. For now the outlook remains murky. However, we've been through many difficult times over the years including market crashes, recessions, Fed tightenings, terrorist events, oil price spikes, geopolitical drama, and the worst bear market in 35 years (and arguably the worst since the 1930s). We also have a deep respect for the financial markets' ability to surprise investors. **We have lived through many troubling times, when investor sentiment was in the dumps, but they were somehow followed by good returns. And when the opposite occurred—nasty market corrections or bear markets—we were able to take advantage of compelling return opportunities that were created.** So while every cycle is different, what is the same is our philosophy of structuring portfolios to capture the best long-term return we believe possible while seeking not to violate the portfolio's one-year risk tolerance. (We don't focus on risk over shorter time periods because it results in excessive conservatism and opportunity cost.) This approach has stood up well over time, and is what you can expect from us going forward.

—Lido Advisors Research Team (10/8/07)

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