
LETTER FROM THE PORTFOLIO MANAGERS

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Did You Know?



Eric M. Kobren

Did you know that 19% of all Americans think they belong within the richest 1% of U.S. households?

... That 82% of people think that they are in the top 30% safest drivers?

... That 80% of students think that they will finish in the top half of their class?



Rusty Vanneman

... That people typically think they will have twice as much money at retirement than the average person, even when comparing themselves to others from their own profession?

In short, individuals are over-confident. While it can be argued that a positive mental attitude is helpful in many ways to enable individuals to have functional, productive, and satisfactory lives, it is not necessarily a helpful attitude in making investment decisions.

Overconfident investors tend to trade excessively, stray beyond their circle of competence, and often use excessive leverage. They also tend to concentrate their portfolio.

Given that investment decisions are made in conditions of uncertainty, and that even the most competent, passionate investment managers are still wrong a significant portion of the time, building a properly diversified portfolio is often the most important thing an individual investor can do.

Did You Know? — II

Did you know that long Treasury Bonds have posted a better annualized return than the S&P 500 equity index over the last 5 calendar years? Over the last 6 years? Over the last 7 years? Over the last 8 years? Over the last 9 years?

For a “long-term” investor, who might state that they don’t need the money for at least ten years (and therefore want to put everything in stocks), this last set of numbers may be a bit of a surprise.

Of course, as with all statistics reported in financial commentaries (and research outside the investment world), the results are dependent on the time frame, both the starting point and the ending point. It could be argued that the time frame chosen (starting from a period of high stock valuations and incorporating the 2000-2002 bear market) was best suited toward an argument for a diversified portfolio.

It’s hard to claim complete innocence on that last point, but nonetheless several things should ring true. First, as demonstrated above, bond total returns can be competitive with stock returns, not just in any given year, but over longer time frames, as well. Risk-adjusted returns (which take volatility into ac-

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count) may even be superior. Of course other leading attributes of bonds include the ability to diversify equity portfolios, particularly in periods of economic slowdowns.

Second, long-term forward (expected) returns are driven by valuations. The stock market became quite overvalued in the late 1990s. Looking back, it should not be a surprise that annualized return of the S&P 500 from 1998-2006 is below average at just under 6% per year. While valuation is a poor predictor of short-term performance, it is important over longer time periods. As value investors often say: "Value will out." Meaning that over time, valuations do matter and that superior long-term returns are often borne from periods of attractive (low) valuations.

Over the past three years, annualized stock market returns have been above average, and as a result, today, many investors want more equity exposure. While given the current environment we are basically market agnostic (neutral in our view on stocks), we are not of the mind to add equity exposure at present.

As money manager and market commentator John Hussman has strongly stated:

"If the parents or the children of Wall Street analysts were to ask for wise investment advice, would the first thought of these analysts really be to encourage stock purchases at a multi-year market high, in a long-uncorrected and strenuously overbought advance, at a multiple of over 18 times earnings on unusually wide profit margins, with wages and unit labor costs rising faster than inflation, while interest rates are rising, bullish sentiment is unusually high, and corporate insiders are selling heavily?"

... We've been here before, and the consequences – though not always immediate – have invariably been bad. There is not a single instance in historical data since 1871 when the S&P 500 traded above 18 times record earnings and there was not a low a year or more later that erased every bit of advantage over Treasury bills. Not one."

One of the interesting things about our profession is that we get to hear and learn from lots of bright people. For every accomplished and proven market analyst like Hussman, we can find many equally accomplished and articulate analysts who completely disagree with him.

Yet another reason why we build diversified portfolios.

Did You Know? — III

Did you know that as of this writing, the Dow Jones Industrials has gone over 930 business days without a single 2% one-day price decline?

Looking at the broader S&P 500, never mind a one-day 2% loss, it hasn't even corrected 2% over any time period since last July – the second longest such period in 53 years.

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Though the recent experience in the market suggests otherwise, the stock market regularly corrects. As the table below shows, the stock market often has 5% and 10% corrections. What we have seen in recent months has been rather extraordinary. Does that mean that something has fundamentally changed within the market? Perhaps, but it's not the most likely answer.

Market Declines Since 1871

% Decline	Number of Occurrences	Frequency of Occurrence	Last Occurrence
greater than 5%	96	Every 1.4 years	2002
greater than 10%	51	Every 2.6 years	2002
greater than 20%	24	Every 5.6 years	2002-03

Did You Know? — IV

Did you know that approximately two-thirds of all mutual fund flows over the last two years have gone into international and global mutual funds?

Did you know that the leading benchmark for developed international equity markets, the MSCI EAFE (Morgan Stanley Capital International Europe, Australasia, and Far East) Index, beat the S&P 500 Index in 2006? In 2005? In 2004? In 2003? In 2002?

But, did you know the S&P Index beat the EAFE Index in 2001? In 2000? In 1998? In 1997? In 1996? In 1995? (Note: EAFE beat the S&P in 1999 by 6%).

Given the strong returns of international markets over the past several years, and given the long-term historical risk reduction properties of adding international equities to a domestic-equity dominated portfolio, the question of whether or not to add international exposure no longer even seems worth asking. Instead, the question now seems to be about how much to invest abroad.

This is all rather interesting. While we are big fans of international investing (it adds to our opportunity set to enhance risk-adjusted performance), we do remember just a handful of years ago where the leading thought was to have NO international exposure at all! The thought back then was that since international markets had underperformed the U.S. for so many years (see above), and also because correlations between international and U.S. markets had risen (meaning international investments didn't diversify as strongly as they once had), that international exposure was just not necessary for investment portfolios. In fact, it might even be harmful.

Note: the annualized return for the MSCI EAFE over the last five years has been approximately 15% (through 12/31/06). The return for the S&P 500 Index over that same time frame has been closer to 6%.

So, how should an allocation to international exposures be sized for U.S. based individual investors? Of course, the answer is, "it depends."

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One important consideration is whether or not the currency exposures are hedged or not. Our general preference is for funds that do not hedge, which means we would get the additional diversification benefits from currency movements.

The United States stock market makes up approximately half of the world's total stock market capitalization. Some studies suggest that should be the benchmark for U.S. investors. Yet, what that doesn't take into account is that most U.S. investors are not fully integrated global consumers, at least not yet. In other words, our incomes and consumption expenditures are primarily denominated in U.S. dollars and not a basket of currencies.

If a typical U.S. investor were to invest significantly in non-dollar assets, they would be introducing a significant risk – currency risk — that may swamp other market exposures and factor risks. While we like the diversification of modest non-dollar exposure, too much of a good thing could ultimately destabilize the investment portfolio and investor experience and thus an investor's ability to “stay the course” with a well diversified portfolio.

Did You Know? — V

Did you know that Kobren Insight Management had a conference call on January 30th. In case you missed it, a replay is available at:

www.kobreninsightmanagement.com/conference_calls/confcalls_index.html

Sincerely,



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