
Letter From The Portfolio Managers

January 2008

A Look at 2008 Through the Prism of the Unexpected

“Prophesy as much as you like, but always hedge.” -- Oliver Wendell Holmes, Sr.

In the tradition of what we have done the last several years, we would like to present a list of potential market “surprises” for the new calendar year. Our definition of a surprise is something considered more likely not to happen, than to actually occur. It need not be a 100-1 shot, in fact we are not looking for that kind of remote outlier, but rather an event that has a reasonable chance of happening, but that is outside of the consensus view. The value of such an exercise is that it forces one to consider alternative scenarios. Not only is this beneficial from a risk management perspective, but it also helps to think outside the box as it is impossible to beat the consensus if one is in the consensus.



Eric M. Kobren

Of course, this is the time of year when we see a lot of these types of forecasts. With exposure to multiple asset classes and money managers, we hear plenty of well-articulated arguments for why various markets will either explode higher or have significant breakdowns. We hear why things are different this time, yet we see plenty of comparisons to why things now are exactly how they once were. With apologies to Ben Franklin, there are only three certainties in life: death, taxes and uncertainty!



Rusty Vanneman

Even though we have our own market views and forecasts, with varying degrees of conviction, we believe in the wisdom of Oliver Wendell Holmes quote above and will always do what we think is the best for most investors, and that is to “hedge” those opinions by building diversified, balanced portfolios. Besides, when viewed from a risk/return perspective, taking a dramatic stand on the markets doesn't seem appealing. If we make a big bet on your behalf, and it is wrong, that could do significant damage to your investment portfolio and long-term objectives. Isn't it better to be a living dog, than a dead lion? (That particular quote is attributed to King Solomon - okay that's it for the quotes.)

With that in mind, we will present our list of potential surprises for 2008, but first, let's recap last year's surprise list. For the most part, we did alright.

Review of our Potential Surprises for 2007

■ ***The Economy Will Do Worse Than Many Expect***

While many were arguing that the worst of the housing market woes were behind us (including, if we remember right, one Alan Greenspan), we felt that housing was going to get worse and eventually negatively impact economic growth.

We got the first part right, as housing did indeed continue to deteriorate over the course of the year. But the economy proved surprisingly resilient, at least through the first three quarters of the year. However, economic growth is expected to have slowed substantially in the fourth quarter of 2007, and several analysts are now calling for a recession in 2008 (some are even saying we are in one now!)

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And while GDP growth may not have suffered, as of this writing, corporate operating earnings growth for the full year is expected to be negative (-0.2%) for the first time since the last recession. (4Q07 earnings have not actually been reported yet).

■ ***The Stock Market Will Disappoint***

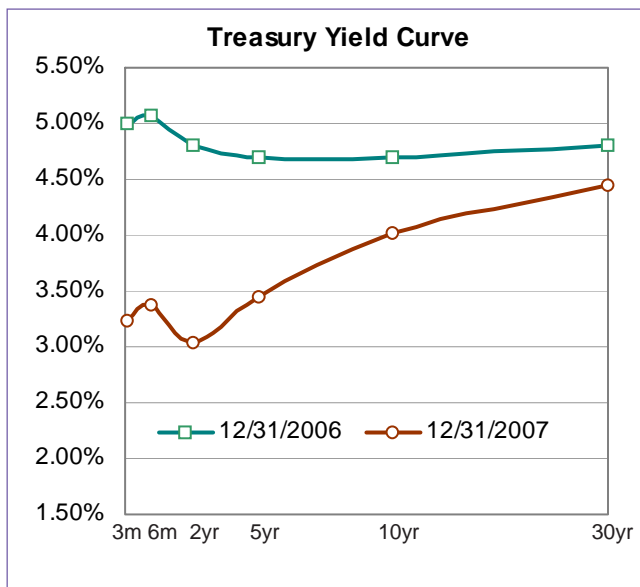
We didn't necessarily call for a negative year for stocks, just one that would be less robust than most were expecting. A year ago, an overwhelming number of professional and individual investors were bullish on the stock market. At the end of the year though, the S&P 500 Index was only up 5.5%, which we think would qualify as a disappointment to most of those bullish investors, especially with bonds, as represented by the Lehman Aggregate Index, returning 7.0%.

■ ***The Dollar Will Be Stronger***

This surprise did not occur. In fact, the U.S. Dollar index continued to decline, dropping over 8% last year. As a result, investing in unhedged international securities paid off for most investors as the international markets in dollar terms outperformed the U.S. market - even though many international stock markets (despite better economic growth) underperformed the U.S. when returns were calculated in local currency terms.

■ ***The Yield Curve Will Get Steeper***

The yield curve is basically the relationship between the market yields on bonds of different maturities. Under "normal" circumstances, the yield curve is upward-sloping as you go further out on the maturity spectrum, due to investors' preference for a greater



yield when committing their funds for a longer period of time.

At the end of 2006, however, the yield curve was inverted with longer-term bonds yielding less than shorter-term bonds. (This condition usually indicates weaker economic growth ahead and in fact the yield curve has been a very good economic indicator — one reason why we had weaker growth as one of our 2007 surprises.)

As for the yield curve surprise, we expected that in response to weaker growth, the Fed would begin cutting short-term rates in 2007, and while long-rates would come down, as well, they would not fall as much as short-rates. As a result, the curve would get steeper. As can be seen in the above chart, the curve did steepen in exactly that manner.

Potential Surprises for 2008

Our potential surprises for 2008 include two that may sound familiar.

■ *The Economy and Corporate Earnings Will Do Worse Than Many Expect*

Currently, according to Standard and Poors, the consensus expectation for operating earnings growth for all of 2008 is 15% year-over-year, with weaker growth in the first half and much stronger growth in the second. While we recognize that earnings growth in the second half will benefit from easier comparisons (the weak second half of 2007), 15% overall growth is, in our estimation, clearly still too high.

According to Ned Davis Research, the long term average earnings growth rate is just 6%, and we see more-difficult-than-average conditions ahead. Principally, we still don't see any signs that the residential real estate market is stabilizing. With home inventories still extremely high, we believe prices need to drop further to clear the excess inventory. Match that with rising unemployment, deteriorating consumer confidence, high energy costs, a credit crunch, and record consumer debt levels, and it is difficult to imagine that consumers will be able to sustain spending at the same levels they have in recent years. While the American consumer has been remarkably resilient, all the data suggests they need to retrench and repair their balance sheets. While this is a long-term positive, in the short-run, it is bad for both economic growth and profits.

■ *The Dollar Will Be Stronger*

Expecting a weaker dollar has been a common bias among investors in recent years, and since 2002, that bias has generally paid off (2005 was an exception). Moving forward though, will it still pay off?

In the third quarter of 2007, U.S. exports of goods and services increased by nearly 20% (thanks, in large part to the lower dollar). This easily outpaced the 4% growth in imports. As a result, the current account balance, as a percentage of GDP, has dropped to its lowest levels in roughly three years. While the trade deficit is still high by historical standards, the improvement in the deficit off its recent peak levels is its best since the early 1990s. Often, market moves correspond to changes in the trend, rather than absolute levels and the dollar will likely be rewarded for the relative improvement in our trade balance.

■ *The Stock Market Will Perform Better Than People Expect*

Many people don't realize that bonds have performed better than stocks over the last decade as shown in the table on the next page. It's a good thing our client portfolios have had exposure to multiple asset classes.

Still, we think stocks could do better than many investors think. For starters, sentiment among individual investors is quite negative. By one measure we look at, investor sentiment is approaching its most bearish levels in nearly 5-years. Given the market is coming

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10-Year Annualized Returns	
As of 12/31/07	
Benchmarks	Return %
Russell 2000 Value	9.1
DJ-AIG Commodity	9.0
Russell 3000 Value	7.7
DJIA	7.4
Russell 2000	7.1
Russell Top 200 Value	6.7
MSCI EAFE	6.6
Russell 3000	6.2
Lehman Brothers Aggregate	6.0
S&P 500	5.9
Russell Top 200	5.0
Russell 2000 Growth	4.3
Russell 3000 Growth	3.8
Russell Top 200 Growth	3.0

off a rare negative fourth quarter, and has had a very rocky start to the New Year, that should not come as a surprise. However, as we have mentioned in the past, only when individual investor sentiment is extremely negative - as it is now - do we see above-average stock market returns over the next twelve months (although it is, of course, no guarantee).

Second, valuations are much better than they have been in over a decade. Although valuations remain above (long-term) average, they have come down, so the headwind of valuations should not be as strong as it has been in recent years. We estimate that valuation compression (declining P/Es) cost the S&P 500 approximately 3% a year in terms of total

returns over the past decade. This should not be the case over the next ten years.

“Wait a minute, didn't one of your earlier surprises suggest that earnings would be less-than-expected?” Yes, but while we don't think earnings will grow 15%, even far more modest earnings growth would be an improvement over the negative growth in 2007. The market often rewards improvement in earnings growth rates, even if absolute levels are not that great. Again, as the saying goes, trend is more important than level.

Third, the interest-rate environment is much better than it has been. As mentioned earlier, the yield curve has steepened. That's a big positive. Credit spreads (the difference between Treasuries and corporate bonds) have also widened, relieving some valuation concerns. And the Federal Reserve is not done cutting short-term rates. Despite a couple of exceptions, “Don't Fight the Fed” has been a rewarding stock market strategy.

■ ***U.S. Stocks Will Outperform International Stocks***

Investment flows into international stock funds have dwarfed those into U.S. equity funds by approximately a factor of 4 to 1 for three consecutive years. That's huge. No surprise there, as the calendar year returns for developed international markets (as defined by MSCI EAFE Index) have beaten the S&P 500's return each year since 2002. Emerging market returns meanwhile, have beaten the S&P each year since 2001. A good part of that outperformance was driven by a roughly 40% drop in the value of the dollar against a broad group of currencies since the beginning of 2002.

We have already talked about the dollar. If it begins to strengthen, international markets will have a much tougher time outperforming. (As we noted above, in general, international markets would have lagged the U.S. last year if not for the dollar's decline.) The

contrarian in us is also concerned about the tremendous imbalance in the investment flows into international funds as investors chase performance.

There is another key factor though: relative valuations. Valuations in international markets were unequivocally cheap relative to the U.S. at the start of the decade. Very cheap. But today, international valuations are no longer cheap. In fact, Asian stocks, ex-Japan, are extremely expensive. The only international market that still looks inexpensive based on relative valuations is Japan.

Here is another interesting point to consider. Currently, Chinese companies dominate the list of the top 20 largest companies in the world in terms of stock market capitalization. Nearly 10 years ago, U.S. technology stocks dominated the list. Ten years before that, Japanese companies dominated that list. How did those former top dogs perform over the next 10 to 20 years?

Don't get us wrong. We are big believers in maintaining strategic allocations to international stocks. Broadening the investment opportunity set clearly adds to the potential to enhance returns and to reduce risk. Over time, maintaining allocations to international securities should pay off in enhancing risk-adjusted performance. That said, from a tactical standpoint, adding to international now (especially when some strategists are recommending over 50% to international!!) seems imprudent.

To reiterate an important point, we have our market opinions, and they are shaped by the work we do internally with our research staff as well as by our conversations with some of the best minds in the investment community today. (Our research team conducted or listened to over 700 interviews with portfolio managers, analysts and other investment professionals in 2007.) And our views do guide us in shaping client portfolios.

Nonetheless, we will continue to build balanced, diversified portfolios, which may include positions in some areas of the market that may not provide instant gratification in terms of returns. We do this because it simply makes sense from a risk-reduction standpoint, and because, even with our experience and tools, we recognize that given the inherent unpredictability of the markets, our forecasts could be wrong.

Sincerely,



Eric M. Kobren
President
Portfolio Manager



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