

Market Review and Outlook—September 11, 2007

What a difference three months makes! In the June report I remarked that we had earned a year's worth of return in three months, that 'your portfolio has earned a nine-month vacation!' Well, the markets indeed rushed out and had quite a vacation. In the past three months, the housing slump has deepened, and a 'sub-prime mortgage crisis' has arisen. The Fed, the Federal Reserve Bank, had an emergency meeting last month to increase liquidity to the markets. During this time, stocks fell from 2 to 7% (or more than 10% for real estate stocks and mutual funds).

What's going on—what is the subprime crisis? Banks no longer lend money and keep the loan on their books. Instead, loans are bundled up and sold out in slices to investors. As more and more levels are added, investors become less and less aware of the underlying loans, and their quality. The housing boom led to more and more aggressive lending (teaser rates for 2 years followed by a large interest rate jump), and to lower- and lower-quality bundles of loans. This house of cards started to shake this summer. One of the problems with this crisis is that its scope is not yet understood. There is no clearinghouse for the size of this problem, or for those affected. PIMCO's Bill Gross guesses that the damage is between \$100 and \$200 billion. Yes, this is a lot of money, however it is only 10 to 20% of the amount that the stock markets have fallen this summer. Doesn't that sound like an over-reaction to you?

What should an investor do? In June I recommended that investors rebalance, likely selling stocks which have risen beyond target levels. I now recommend the same strategy, but with an opposite action: I recommend rebalancing, which at this time likely means adding to your US stocks until they reach your target levels. Rebalancing works quite well in volatile times such as 2007, as long as you maintain this difficult discipline of selling when others are buying and buying when others are selling. The key to investing is to know how much risk you can withstand, and ensure that your portfolio maintains this level of risk, through both strong and weak markets.

While I recommend setting and keeping to long-term targets, I do shift a little here and there based on circumstances. Despite falling this summer, most US stocks are up 5% or so this year, and foreign stocks are up 8% or so. I therefore am not over-emphasizing stocks, but rather building them up to target levels. I might keep foreign stocks a little below targets, given their continued strength. I am ready to slowly build up real estate positions, after being on the sidelines for years. When the subprime crisis passes, high yield and foreign bonds should excel. In these days of low interest rates for long-term bonds, I have begun boosting preferred stocks which pay close to 7% in annual income.

The following data, reflecting results through 8/31/2007, comes from the Wall Street Journal and Morningstar's Advisor Workstation product.

| Category | 3 Months | Past Year | 3-Yr Avg | 5-Yr Avg | 10-Yr Avg |
|--------------------------------|----------|-----------|----------|----------|-----------|
| Money Market—Taxable | +1.15% | +4.70% | +3.06% | +2.14% | +3.38% |
| Intermediate Term Bond | +0.79% | +4.19% | +3.16% | +4.13% | +5.26% |
| Intermediate Muni Bond | +0.01% | +1.76% | +2.42% | +3.09% | +4.26% |
| Large-Cap Blend Stock | -3.50% | +14.60% | +12.24% | +11.48% | +6.38% |
| Mid-Cap Blend | -5.74% | +16.05% | +15.03% | +15.54% | +9.40% |
| Small-Cap Blend | -6.74% | +12.46% | +14.62% | +15.94% | +9.23% |
| International Stock | -2.17% | +19.29% | +21.85% | +17.99% | +7.31% |
| Real Estate | -11.07% | +4.00% | +16.54% | +19.34% | +12.41% |
| Natural Resources | -0.63% | +19.30% | +27.48% | +26.11% | +12.41% |
| Technology | +2.64% | +22.50% | +15.68% | +15.47% | +5.41% |
| Lipper Multi-Cap Growth | -1.00% | +19.37% | +14.48% | +13.62% | +6.38% |
| Lipper Multi-Cap Value | -6.06% | +12.83% | +13.14% | +13.36% | +8.06% |
| Conservative Allocation | -1.19% | +7.27% | +6.31% | +7.01% | +5.21% |

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