



2007 PERFROMANCE REPORT

It was a subprime year. **Subprime** was the word of the year thanks to the real estate crash and a bunch of greedy bankers. We also became familiar with off-balance sheet entities, multi-billion dollar write-downs, and foreign sovereign fund bailouts of our major financial institutions. Subprime is a terrible word. It is designed to make “risky” or “dangerous” sound better. Twenty years ago we called junk bonds “high yield” and had the same problem. We should get into the habit of call things what they are!

The word of the year should have been **reality**. It was the year we stopped fooling ourselves. We stopped thinking real estate prices could grow faster than the income of the buyers. We stopped thinking we could take a bunch of risky loans and package them in AAAs. We stopped thinking we could trust the big banks and brokers to manage money. We stopped thinking cheap oil could fuel the world economy forever and we stopped thinking we didn’t have to do something about it.

Subprime does describe the performance of the stock market last year. Subprime unless you enjoy roller coaster rides. The start of the year was fun as we gained little elevation before taking the first mildly scary dip. That was followed by a steady climb to the middle of the year, which set us up for the summer’s terrifying drop, then another quick turnaround back to the top and another fall to the end, taking us back to about where we started. Want to buy another ticket?

The market’s erratic behavior was understandable given the fear of a financial crises, \$90 dollar a barrel oil and a weakening economy, offset by continued strength in the world economy, Fed easing and healthy corporate balance sheets. Those conflicting trends played out in a market dominated by short-term traders and hedge funds, causing schizophrenic daily volatility but little real progress in either direction.

Stocks, The Favorite Asset Class At This Stage Of The Economy

In all the market turmoil, it’s easy to forget the basic decision every investor has to make. What asset class will make me the most money and protect my wealth? Your choices are: stocks, bonds, cash or real estate. Right now, stocks win, if only by the process of elimination.

Real estate? It typically moves in long cycles and this correction is pretty small compared to the size of the bubble. The demographics aren’t encouraging either. Boomers are over invested in real estate and short the income producing financial instruments they will need for retirement.

Cash? You are getting paid very little, probably less than the real rate of inflation, for parking your money in money markets and other short term investments and it will be getting worse as the Fed lowers interest rates to stimulate the economy. How low short-term rates will go is anybody’s guess but it looks like you will be getting a negative real rate of return (net of taxes and inflation) for some time.

Bonds? Bonds offer some real yield, but it is low by historic standards. The risk in bonds is that you won’t even get that if interest rates go up and you have to sell them before maturity. The risk

of higher interest rates is pretty low in the near term but pretty high when the economy recovers and starts a new cycle of growth and inflation.

Stocks in by default. They are reasonably priced, generally do well in a low inflation, slow growth environment and have the combination of growth and liquidity investors need. How much money you will make in the equity market over the next five to ten years has nothing to do with whether we have recession this year, whether there is another terrorist attack or what happens to the price of oil. Those are short-term events that have very little correlation to what you can expect to make in the market over a reasonable period of time.

As we will show, stocks are incredibly predictable over the long run, but are quite unpredictable over the short-term. Is this risk? You decide.

RISK: A Four-Letter Word, The Chance Of Injury Or Loss

Risk is what you wish you didn't have on days when the financial markets are in turmoil and you're watching your life savings melt away. Risk is what you read about in a disclaimer but never thought would explode in your portfolio. An irrational fear of risk can distort your judgment but people who ignore it are more likely fools than heroes.

The recognition of risk is vital to the efficiently functioning markets. As Alan Greenspan wrote recently in describing the genesis of the current financial crises: "History has not dealt kindly with protracted periods of low risk premiums." Risk isn't the problem, ignoring it is!

THE LEGAL DEFINITION

Judge Samuel Putnam wrote the definitive statement on investment risk 177 years ago. When asked to define fiduciary responsibility, the Boston judge articulated what came to be known as "The Prudent Man Rule" for managing risk.

"Do what you will, the capital is at hazard...All that can be required of a trustee to invest is, that he [sic she] shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital invested."

The statement immediately dismisses the idea that investments can be made without "hazard." There will always be risk but there need not be "speculation" if there is an "intelligent...permanent disposition of funds." The judge clearly saw the difference between short-term speculators and long-term investors. He also recognized the investor's basic dilemma, the trade-off between "probable safety" (risk) and "probable income" (reward).

"To observe how men of prudence, discretion and intelligence manage their affairs" is by far the most difficult of the judge's charges. Citibank, Morgan Stanley and Merrill Lynch are among the largest fund managers in the world but those firms recently were forced to write down tens of billions of dollars in losses because they failed to observe the most rudimentary rules of risk management. Apparently we should look elsewhere when selecting fiduciary role models.

We prefer legendary investors like Warren Buffet, John Neff and David Dreman, men who have spent their lives accumulating vast wealth for their clients. They are classic long-term investors

who understand that short-term volatility in the market is so much noise and risk needs to be measured in years and decades, not daily averages.

WHAT WE KNOW WORKS

Fortunately, we have learned something about risk management in the last 170 years. We can quantify the risk of various investments, calculate the stability gained by various levels of diversification and project the probable outcomes of a portfolio structured for a client's tolerance for risk and income requirements. We can't eliminate risk, but we can say with some certainty how to control it.

Matching your asset's maturity to your need for the money

We know that short-term assets are safer than longer dated ones but it is important to remember that they provide less long-term stability. The most conservative investment plan is to have securities mature when you need the money, not before and not after. That's why funding your long-term retirement needs with CDs isn't safe. You have no idea what your yield will be next year much less ten years from now when you need the money.

Diversification is one of the cardinal rules of risk management.

Owning a great number of securities in the same asset class lowers risk as long as riskier assets are not substituted. Diversification is not just a matter of the number of securities in a portfolio, it is making sure they are representative of a variety of industry groups and market caps for equity portfolios and maturities for fixed income portfolios.

Balancing a portfolio between stocks, bonds and cash is the surest way to limit risk

We believe strongly that the decision of how to balance a portfolio between stocks, bonds and cash should be made by the investor and rarely changed. It is the ultimate statement of risk preference that every investor needs to communicate to his investment advisor. It should be formulated based on the investor's needs, not the manager's view of the market or short-term circumstances. Once decided on, the asset balance should change only when the investor's circumstances change.

The historic risk of an investment can be predictive of future results.

The history of an investment is predictive of the future as long as the investment climate remains the same. Just looking at how gold performed during a period of hyperinflation doesn't help you a bit if you want to know if it is a good long-term investment. Picking mutual funds or money managers based on recent past performance is equally silly. The risks you care about can only be measured in multiple investment climates but clearly investments that have been highly volatile in the past can be expected to continue that pattern.

Professional management limits risk.

It can also improve your results as long as your goals are the same as the manager's. Buying a mutual fund whose management is focused on beating the growth fund index quarter by quarter makes no sense for someone who's trying to send a kid through college ten years from now. Having someone intelligently select a stock portfolio for long-term capital gains does.

The basic rules of risk management when applied by prudent men will yield the best balance between risk and return. It will never yield a high return, risk free portfolio but it should avoid a low return, high-risk portfolio. It will not protect you from absolute risk. If the financial system suddenly melts down prudent and imprudent men will both lose money. Proper risk management will only give you a fair balance between risk and reward, not guarantee you against losses.

INVESTMENT RISK

Most professional money managers view risk very differently than the probability of absolute loss. They view risk as deviation of returns from the market. If the stock market goes down 20% but they go down 15% they think they are doing a great job. Of course, if the market goes up 20% but they are only up 15%, they don't expect a raise; but the point is, they have a benchmark and it is seldom an absolute number. That may be at odds with their clients who expect an absolute rate of return. We try to overcome this conflict by being honest.

We would love to be able to tell investors that we have found the holy grail of investing, that we could produce constant absolute returns and beat the market. We can't do it and we think that anybody who says they can is either a con man or a fool.

We can design portfolios that are safer or more aggressive than the market with the predictable trade-off in returns but about 80% of what happens to our client's portfolios is due to the market, not our management. We can deal with the fact our client's money is subject to market forces because we don't think that having a return that is tied to the market is a problem. The equity market is unpredictable and even fickle in the short-run but for investors with patience, the market has been an incredibly predictable source of wealth creation.

Because we believe the market is our friend, we create portfolios that try to avoid overpriced securities while still gaining exposure to the broad market. The balance of portfolios between stocks, bonds and cash will primarily be dictated by your needs. How much growth do you need, how much income and what is your time horizon? These factors will determine how we find a fair balance in your portfolio between risk and reward.

FINDING THE FAIR BALANCE

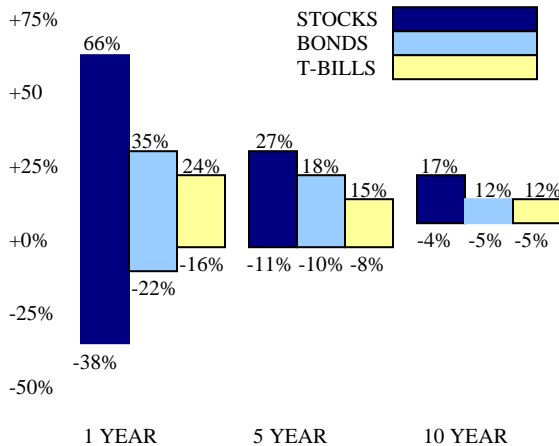
If risk must be weighted against reward what is a fair balance? Are all transactions that have a probability of making money good and all that have a likely negative outcome, bad? Insurance is a guaranteed negative outcome in that the aggregate premiums collected must always exceed the claims paid but it is not a bad investment. If I were to design a lottery that paid out \$500,000 to one winner but only sold 400,000 \$1.00 tickets it would have a net investment gain of 20% but your chances of winning on any one ticket would still be 400,000 to one. Isn't that a risky investment even though the reward outweighs the risk?

Choosing a balance is clearly dependent on the investor as much as the investment. For play money, that lottery ticket might be OK but for your life savings, it isn't. For a small amount of money insurance makes sense but it is silly to be over insured to the point that the cost is diminishing the assets you are attempting to protect.

The needs of the investor are paramount when choosing a balanced asset allocation. Historically, stocks have outperformed bonds and cash equivalents (money markets, CDs) about 90% of the time for any ten-year period but that does not make them an appropriate investment for all of

somebody's money that has a one or two year investment horizon. What that investor needs to know is something like the chart below

MAXIMUM AND MINIMUM REAL COMPOUNDED ANNUAL HOLDING PERIOD RETURNS (1802-1992)



Worried about stock market risk? The cure is time. This chart includes returns during our civil war, two world wars, three depressions (including the great one), hyperinflation, deflation, panics and world wide crises. Unless things get worse than that, you can be pretty sure that over a ten year period: A; you will make more money in stocks than any other asset class and B; your risk will be pretty low, less than even T-Bills or bonds held for a shorter period of time, BUT ONLY IF YOU HAVE A TEN YEAR TIME HORIZON.

THE VIEW FROM ACADEMIA

Academics define two sources of portfolio risk. Systematic risk is what happens to the market. Non-systematic risk is every thing else that can make your portfolio act differently than the market indexes like trading, individual stock selection and pure damn luck. You can mitigate or even eliminate systematic (market) risk by creating portfolios that look nothing like the market averages. The extreme example of this would be an account that is 50% long and 50% short equities. That may or may not work out but everything we know about your chances of making money and risk from historic market data gets thrown out the window because you don't own the market, you own something else.

If you eliminate market risk (and reward) you just have a trading account. You have eliminated market risk but you have also eliminated the market's upward bias. In effect you have taken a market where the odds were in your favor and turned it into a casino where the odds are stacked against you because there is no upward bias in trading, just a lot more expenses. Given the choice between accepting risks that we know are inherent in the market, versus the unknown risks of excessive trading and portfolio concentration, we'll take the market.

In all the years we have been managing money we have seen a lot of industry groups and market sectors overpriced enough for us to avoid them, but we have never said that of the entire stock market. Perhaps some day we will, but it's not likely in the near term. If we did, it would be on the basis that valuations are extreme across the board, there are fissures in the financial system that will take many years to repair or the world has become hostile to domestic corporations. We hope we never have to try to make that call for US equities.

We'd like to think that if we were managing money in Japan twenty years ago we would have sold most of our Japanese equities.

Barring the extreme example of an obviously dysfunctional economy, we are content to ride the ups and downs of the market. Some people's personalities make that ride impossible. If you

define risk as market fluctuations instead of the chances of making a good return on your money over a ten-year period of time, you will be a very unhappy stock investor. If you think you can or should control the daily value of your portfolio and judge your success or failure by each security's profit or loss, save yourself a lot of agony and either put your money in blind trust or a bank account that doesn't get quoted in the paper.

MR CD VERSUS MR STOCK

Let's explore these two polar opposites in risk perception. We'll call one Mr. Stock and the other Mr. CD. Mr. CD asks Mr. Stock how he sleeps at night knowing that he could wake any morning and find that the value of his investments has gone down 30% or more because markets around the world crashed. Mr. Stock responds that he sleeps just fine because he doesn't need the money tomorrow morning and knows that in the long-run, he has a much better chance of making real money (after inflation and taxes) than Mr. CD. Mr. Stock points out that equities have beat short-term investments in about 90% of ten-year periods this century, making him quite confident that his money is better invested than Mr. CD, who's short-term holdings have rarely made money in real terms.

Yes, says Mr. CD but that's history and the *New York Times* says that we are headed for an environmental disaster. The *Wall Street Journal* says the banks are all bankrupt and Fox News says when the democrats get in a recession is guaranteed. Mr. Stock goes on-line and brings up headlines that were just as dire in 1982, 1987, 1992, 1997 and 2001. He then patently shows Mr. CD the subsequent high double-digit return for stocks in every period that followed a prediction of eminent doom.

OK, says Mr. CD, I'll buy some stocks but I'll watch them like a hawk and sell them as soon as I see a declining market, so I'll never have to experience a big correction like the one Mr. Stock will invariably have to suffer. That way I can manage my risk.

Nice try Mr. CD, but it won't work. For one thing, when the big one hits it will probably be an event so severe that markets will close before you can sell and open at their lows. Even if the markets slide were a slow one, how would you know when to get out and when to get back in? In all likelihood, the slide would be accompanied by fake moves up and horrifying declines that would drive market timers crazy. Get it wrong and you can actually end up losing more than the market gives up, as you buy the rallies and get whipsawed in the next decline. That kind of trading doesn't sound like risk management to us.

What we know works in risk management is the exact opposite of short-term trading. What we know works is matching an asset's term to the investor's liquidity requirements.

We can help our clients sleep at night by using a balance of stocks, bonds and cash to make their portfolios as safe or aggressive as they want them to be. We can see the benefits of diversification every time one of our stars becomes a comet overnight. We believe that our investors can be protected from some obvious risk by avoiding the hot momentum stocks altogether, instead of trying to get out before the inevitable crash. Given the choice between the very unlikely probability of making money in short-term investments and the near certainty of better returns in stocks and bonds, we'll take the latter regardless of the newspaper headlines.

SUBPRIME RISK

We know that we are in the midst of a financial crisis, when a stock goes up because the firm only wrote off two billion dollars instead of the five to seven billion that had been rumored. We are pretty sure there's a problem when heads begin to roll at the top of major brokerage firms, where previously you had to commit a felony to lose your job. It's probably not over, but it's getting better now that the banks have begun to take their losses instead of creating off-balance sheet funds to bail out their old off-balance sheet investments. Every time we see another write-down, we do a mental calculation to see how close we are getting to finally knowing which firms have to take that half a trillion dollar loss we projected they needed to take before it was all over.

All this is pretty scary but it's still no worse than we thought it was last spring. In that newsletter we estimated the sub-prime and derivative problem at roughly 500 billion dollars, which still looks like a good guess.

We'll never see all the losses because they will be taken against profits somewhere else, stashed overseas or buried in an investment portfolio that doesn't have to be marked to market. Underlying it all is the question yet to be answered: How many people will default on their home mortgages? The truth is nobody knows but there is a limited number of people who will choose personal bankruptcy, a big tax bill and loss of credit to get out from under a house payment, even if they do have negative equity. Houses aren't investments any more but they are still shelter.

The sub-prime mess and associate credit crunch is as big a problem as we thought it would be but it's still perfectly manageable in a thirteen trillion dollar economy. It's a lot less scary than the S&L crisis of the nineties was because we don't have high interest rates, high unemployment and a weak economy the way we did in the late nineties. It will cause a lot more damage before it's all over but it's not the end of the world, just the bursting of the housing bubble that everyone knew, or should have known, would have to deflate someday.

ALL THE OTHER BAD NEWS

OK, but how about \$100 a barrel oil, the effect of declining housing prices on the consumer, the falling dollar, the mess in the middle east and terrorism. Aren't these problems enough to kill the economy and cause a big bear market? Maybe, but when? These problems have been around for some time now and so far the economy has slowed a little but hardly ground to a halt.

It seems to us that we are having a perfectly normal and much needed, slowdown in a robust world economy that is still in the middle of the greatest increase in wealth in the history of man.

If the slowdown turns into a recession we'll be disappointed but hardly surprised. Recessions happen! The stock market will go down 20% or more, we'll be able to buy any stock we want at a huge discount to its real value and in a few years we'll have made a fortune. That's risk management. It's not holding 50% cash on the 25% chance that we'll have a recession or trying to "be defensive" by just holding stocks with higher dividends but no growth when great growth stocks are being given away.

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