
Letter From The Portfolio Managers

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In Like a Lion... Out Like a Lamb



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Out Like A Lamb...

The stock market's performance in March held to the old saying about March's weather: "In like a lion and out like a lamb." A month ago, we wrote how the stock market was off to its worst start in nearly 70 years. By quarter-end, however, thanks to the S&P's nearly 10% rally off the intra-day lows set on March 17th, we can now state that the market is off to its worst start in "only" 7 years. We'll take improvement where we can get it. We're glad the book has been closed on the eventful and volatile quarter.



Rusty Vanneman

Comparing the markets to the weather is apt. Neither can be controlled. While both may display short-term momentum at times, neither can be predicted with a high degree of accuracy in the foreseeable future.

That said, though, like everyone knows that the cold weather of winter will eventually turn into springtime and eventually into the heat of summer, and vice versa, long-term investors know that periods of high market valuations will turn into lower market valuations and that low stock-market returns will eventually turn into higher market returns.

Due to the market correction in recent months, stock market valuations are now back at levels not seen in many years. In short, the long-term forecast for stock market returns looks better now than it has in years.

What exactly is "Long Term?"

What is meant by "long-term" in investing? Different voices provide different definitions, but the consensus generally says that around ten years or more qualifies as long-term. This contrasts to "short-term" time horizon, which many would say is two years or less.

The reason these time frames are important is because investors need to match an investment portfolio with the highest probability of meeting their investment objective. When investing for short-term liabilities, for instance, it is important to emphasize capital preservation to maximize the chances of actually being able to meet those short-term obligations. Emphasizing fixed-income and cash instruments may sacrifice some return potential, but their probability of providing a positive return over a short time period is higher than it is for equity-oriented investments.

As for long-term investment objectives, the emphasis shifts away from relatively stable securities to those securities that can typically provide higher total returns over time. The stock market for instance,

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while clearly more volatile in the short-term and thus more likely to generate short-term losses than bonds, generally provides higher total returns over time. For the long-term investor, emphasizing equity-oriented investments, which participate in the long-term growth of the economy, is the higher probability way to build a portfolio. Of course the degree of equity exposure for each investor is a determined balance of return and risk and primarily depends on each individual's own risk tolerance and unique considerations and objectives.

Ten-Year Returns – Now and Ten Years Ago

So, let's look at the 10-year annualized returns. First, we will examine the 10-year returns at the end of March 2008, and then we'll look at the 10-year numbers from March 1998. There are lots of items worthy of comment. First though, let's review the numbers.

Over the last ten years, the top performing asset classes were commodities, emerging international markets, and real estate investment trusts (REITS). The bottom performing benchmarks were the growth stock benchmarks, with the Russell 200 Growth index, which represents large cap growth stocks, at the bottom of the list.

<i>Annualized Returns through 3/31/08</i>	
Name	10 Year Return through 03/31/08
Dow Jones AIG Commodities	10.39
MSCI Emerging International Markets	9.74
FTSE NAREIT Real Estate Investment Trusts	9.64
Lehman Brothers US Treasury US TIPS	7.97
Russell 2000 Value (small cap value)	7.46
Lehman Brothers US Treasury Long	7.40
Lehman Brothers US Aggregate Bond Index	6.04
Russell 3000 Value (value stocks)	5.63
Dow Jones Industrial Average	5.47
Russell 2000 (small caps)	4.96
Lehman High Yield Bonds	4.84
Russell Top 200 Value (large cap value)	4.46
MSCI EAFE Developed International Markets	4.14
Russell 3000 (total U.S. stock market)	3.88
Merrill Lynch 3-Month T-Bill (cash)	3.73
S&P 500	3.50
Russell Top 200 (large caps)	2.63
NASDAQ Composite	2.19
Russell 2000 Growth (small cap growth)	1.75
Russell 3000 Growth (growth stocks)	1.29
Russell Top 200 Growth (large cap growth)	0.38

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Now, let's look at the 10-year annualized numbers from 10 years ago (one note – commodities only go back to 1991). In this case, the bottom performing asset class was developed international markets and the top performing asset class was domestic large cap growth stocks.

<i>Annualized Returns through 3/31/98</i>	
Name	10 Year Return through 03/31/98
Russell Top 200 Growth TR USD	20.22
DJ Industrial Average TR USD	19.47
Russell Top 200 TR USD	19.39
S&P 500 TR	18.94
Russell 3000 Growth TR USD	18.70
Russell Top 200 Value TR USD	18.47
Russell 3000 TR USD	18.42
Russell 3000 Value TR USD	18.11
NASDAQ Composite PR USD	17.23
Russell 2000 Value TR USD	16.44
Russell 2000 TR USD	14.86
MSCI EM USD	13.77
Russell 2000 Growth TR USD	12.95
FTSE NAREIT All REITs TR	10.88
LB US Treasury Long TR USD	10.78
LB US Agg Bond TR USD	8.94
DJ AIG Commodity (7-year Annlzd return: 4/91-3/98)	6.23
Merrill Lynch 3-Month T-Bill (cash)	5.83
MSCI EAFE USD	3.55

The first thing that is interesting in these tables is how vastly different each time frame has been in terms of the magnitude of total returns (though both show positive returns across all asset classes). The current 10-year annualized returns, for example, are lower than historical averages. Then again, given the level of financial market valuations ten years ago, this shouldn't be too much of a surprise (even though the economy actually produced above-average growth over the last ten years!). In addition, the annualized 10-year returns from a decade ago were clearly above average. Given the cyclical nature of markets, it would be reasonable to expect low-return environments to follow high-return environments – and vice versa.

Even in the low-return environment, it should be pointed out that equity-oriented investments — the more volatile asset classes — tended to generate the higher total returns over time. Bonds have clearly been competitive over the last 10 years, but the top performers were still those asset classes participating in economic growth.

I think the table above also speaks to – both for and against — the concept of “buy-and-hold” investing. First off, we believe, and the data above appears to prove, that there is no one investment that a long-term investor can just buy and hold and not think about again. Conceptually, however, buy and hold investing has some extremely important attributes, which are key to a successful investment philosophy, such as a long-term outlook, minimization of transaction costs, and an equity orientation. Still, it doesn’t really mean buying one asset class and forgetting about it.

Besides, note how the best performing asset classes generally became the worst ten years later. How did the worst asset classes from ten years ago become the best in the most recent ten years? After looking at this data, the long-term investor should keep in mind the saying that “the first shall be last and the last shall be first.” Chasing performance is the worst example of poor investment behavior and the leading reason why many investors have difficulty achieving satisfactory returns.

Which is why most investors would be best served in balanced, diversified portfolios. Instead of chasing the investments that did best historically, investors should stay consistently invested in a portfolio of multiple asset classes to participate in long-term global economic growth.

What Exactly is a Balanced, Diversified Portfolio?

A “balanced, diversified portfolio” is an expression that’s often used, but exactly what does it mean?

A “balanced” portfolio is typically defined as a portfolio that maintains exposure to multiple asset classes, creating a balance between return and risk. Balanced funds can often be called “asset allocation” or “allocation” funds. At Kobren Insight Management, the allocation among various classes is primarily driven by the individual client and her or his investment objectives, time horizon, risk tolerance and other unique considerations. The secondary consideration, which modifies the strategic allocation decision for each client, is Kobren’s return and risk outlook for various asset classes.

A “diversified” portfolio meanwhile, is a portfolio that is not concentrated in any one specific market exposure or security. It is the opposite of a concentrated portfolio. Diversifying a portfolio can reduce portfolio risk in a couple ways, including reducing security specific-risk (the risk that one security could materially hurt performance; also called idiosyncratic risk) and reducing overall volatility. Most mutual funds are excellent examples of diversified portfolios. While some mutual funds are actually classified as “non-diversified,” most funds typically do not concentrate their portfolio on a single market exposure or two. In fact, the typical mutual fund owns nearly 250 individual securities. As a result, mutual fund portfolios tend to display much lower volatility than a portfolio consisting of a few single securities.

Why Balanced, Diversified Portfolios *Should* Work

There are various reasons why balanced, diversified portfolios work for the long-term investor. First, balanced, diversified portfolios provide steadier returns. In other words, they display less price volatility. Various studies of investor behavior have shown that lower volatility portfolios are more attractive to investors and thus investors are more likely to stick with them during periods of increased market volatility. While volatility can mean opportunity to the investor with the time, interest, and expertise to take advantage of it, for those investors busy doing other things, volatility can often be distracting and destabilizing.

Staying invested in a balanced, diversified portfolio through various market cycles can typically provide investors a better experience than trying to time the market by buying and selling at the wrong time, which is often the case. In addition to minimizing poor investment behavior, staying invested in an appropriately balanced and diversified portfolio generally means that an investor will maintain a higher average allocation over time to higher returning asset classes, such as the stock market. It may even enable an investor to modestly participate in the highest risk asset classes (for example emerging market equities), something that is extremely difficult to do when that asset class is the sole investment.

A diversified portfolio also minimizes the damage from individual securities that may “blow up.” All the great investors have had high conviction trades that will go sour on them. Yet, they were able to stay in the game because they diversified. Why concentrate on one big bet or two and risk permanent damage to an investment portfolio? As we have said before, investing and gambling are two separate activities.

Why Balanced, Diversified Portfolios Might Not Work – At Least in the Short Term

In the short term, investors can become frustrated with balanced, diversified portfolios. Typically, it is during times when the relative performance difference between balanced, diversified portfolios and the domestic stock market is greatest.

For instance, when the S&P 500 dominates all other benchmarks, especially the non-equity asset classes, many begin to question the value of having any exposure outside the S&P 500. This has been seen before and will be seen again. Still, as can be seen by the historical numbers, just as sure as the S&P will rotate to the top of the performance charts, it will surely rotate back to the bottom.

Remarkably, another time that balanced, diversified portfolios typically come under pressure from clients is when they handily beat the S&P. This is usually when the S&P is posting absolute losses. At that point, many investors simply don't want any exposure at all to the stock market. Again, though, after the S&P have suffered losses, this is often the worst time to trim exposure to the stock market.

Summary

In closing, we believe that the balanced, diversified portfolio is the all-weather investment approach that should suit the purposes of most investors. While specific life changes will gradually modify an individual's balance of assets over time, the steady approach should help most investors eventually attain their long-term goals. The key is to maintain a disciplined, long-term orientation and stay invested. As the investing legend Sir John Templeton said, "History shows that time, not timing, is the key to investment success."

Sincerely,



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