

Second Quarter 2007 – Market Review

With the return of volatility defining the global financial markets in the first quarter, the second quarter witnessed rising stock markets, falling bond prices and continued weakness in the residential real estate markets. U.S. consumers, despite record-high gasoline prices and a deepening slowdown in the housing markets, did their part to keep the economy growing. Strong global economic conditions, especially in Europe and Asia, continued to foster overall economic growth in the United States and around the world. Investors shrugged off political and military setbacks in the Middle East and focused instead on peace and prosperity at home, pushing the S&P 500 Index to an all-time high of 1,539 on June 4th.

Large cap stocks were up 6.3% in the second quarter. Large caps have now outperformed mid cap and small cap stocks over the last 12 months for the first time in nearly seven years! The one-year return of 20.6% for large caps outpaced the 18.5% and 16.4% returns for mid caps and small caps, respectively. Over longer periods of time, large caps have some catching up to do relative to their smaller cap brethren, and it appears that the tide may finally be turning in their favor. We can't say with any certainty how long large caps will outperform mid and small caps. We all know that returns on various asset classes wax and wane. Moreover, successful investing does not mean that one has to successfully time the market, but one has to be disciplined.

We find that a successful long-term investment approach is akin to farming; we know that there will be good and bad seasons. Successful farmers don't just plant crops in what they hope will be good seasons, as it is impossible to know in advance how the growing season will pan out. They plant crops every year and they diversify their crops by season and by type knowing that only some of their crops will produce great harvests. Of course, a successful farmer must also use all his knowledge and experience to successfully navigate each growing season.

Asset Class Returns - Before the Impact of Inflation						
	Investment Type (Index)	2nd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	6.3%	20.6%	11.7%	10.7%	7.1%
	Mid Cap (S&P 400)	5.8%	18.5%	15.2%	14.2%	13.4%
	Small Cap (Russell 2000)	4.4%	16.4%	13.5%	13.9%	9.1%
	International Equities (MCSI EAFE)	6.4%	27.0%	22.2%	17.7%	7.7%
	Commodities (Dow Jones AIG)	-0.1%	2.9%	9.7%	14.4%	7.4%
	Real Estate Investment Trusts (NAREIT)	-9.0%	12.6%	21.1%	18.6%	13.2%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	-0.5%	6.0%	3.8%	4.9%	6.3%
Cash	Cash (T-Bills)	1.3%	5.2%	3.8%	2.7%	3.6%
	Inflation (CPI)	1.6%	2.7%	3.2%	3.0%	2.7%
Asset Class Returns - After Inflation						
	Investment Type (Index)	2nd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	4.7%	17.9%	8.5%	7.7%	4.5%
	Mid Cap (S&P 400)	4.2%	15.8%	12.0%	11.2%	10.7%
	Small Cap (Russell 2000)	2.8%	13.7%	10.3%	10.9%	6.4%
	International Equities (MCSI EAFE)	4.8%	24.3%	19.0%	14.8%	5.0%
	Commodities (Dow Jones AIG)	-1.7%	0.2%	6.5%	11.4%	4.8%
	Real Estate Investment Trusts (NAREIT)	-10.6%	9.9%	17.9%	15.7%	10.5%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	-2.1%	3.3%	0.6%	1.9%	3.6%
Cash	Cash (T-Bills)	-0.3%	2.5%	0.6%	-0.2%	1.0%



Burj al-Arab Hotel, Dubai

Last quarter we discussed our concerns about Real Estate Investment Trusts (REITs). We wrote that, “Over the last five years domestic REITs have produced an average annual return of 24.1%” and we suggested that, “It is very unlikely that results like this continue over the next five years.” Well, sometimes our predictions come true rather quickly, as REITs fell 9.0% in the second quarter! Six months ago we repositioned our exposure to REITs away from domestic markets and towards global real estate markets where the decline was less. The REIT or REIT-like structure has now been adopted in 19 countries including France (in 2003), Malaysia (2005), Thailand (2005), Dubai (2006), Israel (2006), and the UK (2007). Germany and Italy are also expected to do so this year, and Spain and Finland are considering doing the same. While our current exposure to REITs is small, over time the continued securitization of global real estate is likely to offer investors some good opportunities and potential returns that do not move in tandem with stocks and bonds. We will be monitoring the attractiveness of this asset class and look forward to “planting more seeds” in this area at some future time.

Foreign stocks, as measured by the MSCI EAFE Index, rose 6.4% during the quarter. Stocks in Europe rose 8.3%, while Asian stocks rose only 0.3%. Stocks in Portugal and Germany led the way, gaining 17.6% and 16.2%, respectively, during the quarter, while Japan was the only developed nation to experience negative returns, down 0.6%. Emerging market stocks rose 15.0% in the second quarter. In China stocks soared 24.5% and stocks in India gained 20.8%. Some emerging markets posted very impressive results: stocks in Peru rose 33.6% (now up 67% this year), Hungarian stocks rose 28.7%, and stocks climbed 23% in both Brazil and Pakistan during the quarter. Sri Lankan stocks posted the weakest results, falling 8.5%.



Taipei 101, Taiwan - The world's tallest building with 101 floors.



Burj Dubai – Pictured here at 140 floors, this will soon be the world's tallest building when completed in 2009 at over a half mile high and with an estimated 195 floors.

The second quarter was a difficult one for bonds as interest rates rose and bond prices fell. The Lehman Brothers Aggregate Bond index (a mix of government and corporate bonds) fell 0.5%, inflation adjusted bonds fell 0.8% and international bonds lost 0.7%. Returns on cash were 1.3%.

The Federal Reserve has kept interest rates unchanged for 12 straight months, stressing that inflation continues to be the biggest risk to the U.S. economy. Over the three month period ending May 2007, the annualized rate of inflation was 7.0%. Inflation, however, can be quite volatile and over the last 12 months the inflation rate was a more reasonable 2.7%. Still, this means that money must return at least 2.7% after tax to maintain its purchasing power – stuffing it under a mattress will not do. Of course, everyone’s inflation rate is different. It all depends on where you live and how you spend your money. For example, over the last 12 months, some items have seen high inflation rates: education (6.0%), medical care (4.0%), food (3.9%), housing costs (3.3%), and gasoline (6.0%). If you don’t go to school, need medical care, eat or drive, then inflation is not an issue! For the rest of us, it is vital to invest to protect against its effects.

“Money is better than poverty, if only for financial reasons.” Woody Allen