Third-Quarter 2007 Market Review ~ Who am I? Why am I here?

October 2007 - Stock and bond markets were whipsawed during the third quarter. At the outset, stocks continued on the upward trajectory started during the first half of the year, with the Dow Jones Industrial Average setting an all-time high on July 19th at a smidgen above 14,000. But by the end of the month, stocks began to swoon due to concerns about a weak housing market and tight corporate credit. This lead to a massive re-pricing of risk in the residential mortgage and corporate credit markets, widening bond spreads and lowering fixed-income prices.

To address the credit-market distress, in August the Federal Reserve added liquidity to the system by engaging in open-market operations and, in an unusual move, cutting only the Discount rate by ½%. The Discount rate is the rate charged member banks when they borrow directly from the Fed, whereas the more widely-publicized Fed Funds rate is the overnight rate banks charge each other. On September 19th, the Fed lowered both the Fed Funds and Discount rates by ½% to 4.75% and 5.25%, respectively.

By quarter end it was "much ado about nothing" for stocks, as most market barometers went on to post advances. Meanwhile, the credit-market turmoil spurred a monsoon flight-to-safety which sent the yield on the 10-year Treasury Note below 4.40%. The 10-year Note was down 41 basis points for the quarter to close at 4.62%.

Below are rates of return for selected market indices for the third quarter of 2007, year-to-date 2007, and the three, five, and 10-year averages as of December 31, 2006.

	3Q:2007	YTD-2007	3-Yr. Avg.	5-Yr. Avg.	10-Yr. Avg.
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	4.21%	12.68%	6.87%	2.69%	5.44%
Russell 1000 - Value	-0.24%	5.97%	15.09%	10.86%	11.00%
Russell 1000 - Blend	1.98%	9.30%	10.98%	6.82%	8.64%
Domestic Small Cap					
Russell 2000 - Growth	0.02%	9.35%	10.51%	6.93%	4.88%
Russell 2000 - Value	-6.26%	-2.70%	16.48%	15.37%	13.27%
Russell 2000 - Blend	-3.09%	3.16%	13.56%	11.39%	9.44%
Real Estate (Dow Jones Wilshire REIT)	1.42%	4.64%	27.26%	23.79%	15.27%
International Developed Large (MSCI EAFE)	2.23%	13.57%	20.52%	17.02%	9.96%
International Developed Small (MSCI EAFE)	-4.43%	6.92%	25.86%	26.46%	NA
International Emerging Markets (MSCI EM)	14.52%	34.85%	31.03%	28.67%	13.99%
Fixed-Income (Bond) Indices					
Lehman Brothers					
Global Aggregate	5.61%	6.02%	3.81%	8.09%	5.75%
U.S. Aggregate	2.84%	3.85%	3.70%	5.09%	6.31%
U.S. Corporate High Yield	0.33%	3.21%	8.57%	10.66%	6.97%
Municipal	1.83%	1.97%	4.28%	5.55%	5.82%
International Emerging Markets	2.05%	3.07%	11.37%	14.66%	11.31%

Source: www.russell.com, www.wilshire.com, www.mscibarra.com, www.lehman.com

Who am I? Why am I here?
(Do you have an Investment Philosophy?)

There's more to these words than the mere utterances of philosophy professor and vice-presidential nominee James Stockdale. These rhetorical questions posed by a relative unknown as his opening remarks in a 1992 debate were left unanswered, so the highly-decorated Navy officer never had the opportunity to explain how his values and beliefs guided him to develop his political positions. Remarkably, he was later quoted to say: "I never had a single conversation about politics with Ross Perot in my life; still haven't." So much for Perot's approach to portfolio selection…

Do you have an investment philosophy for your portfolio? Has your financial advisor explained his/her investment philosophy? Does your financial advisor even have an investment philosophy? First, what is an investment philosophy? It is a set of guiding principles which provide a framework for how an investment portfolio is managed. This includes decisions about how the investments will be selected, as well as how the portfolio will be constructed and managed. All of the investments in your portfolio should be able to answer the questions 'Who am I? Why am I here?'.

In April, we wrote about Portfolio Spring-Cleaning (See Portfolio Spring-Cleaning Revisited at www.kaloramawealth.com/news.html) to provide a framework for "what" should be done to organize and optimize the performance of your portfolio to achieve your goals. We followed up in July with the "how" of Portfolio Spring-Cleaning by providing the steps in the Investment Management Process (See Commencing Countdown, Engines On! at www.kaloramawealth.com/news.html). This article discusses the "why" of Portfolio Spring-Cleaning by outlining an investment philosophy.

As an investor, you should not only know in which investments your money is invested, but more importantly, "why" the investments were chosen. An investment philosophy should comprise investment strategies based upon sound financial and economic principles which emphasize low costs and tax efficiency. Investments should be selected based upon quantitative and qualitative analysis, and portfolios should be constructed using a process to maximize after-tax total return within an investor's risk tolerance and time horizon.

Kalorama Wealth Strategies embraces nine investment philosophy principles:

1. Transparency

Transparency in the financial markets means the full, accurate, and timely disclosure of information which provides the investor knowledge about a company or investment. Clear and easily understood processes provide clients access to information so that knowledgeable decisions can be made.

2. Fee-Only Compensation, No Commissions

A fee-only compensation structure aligns the interests of the advisor and the client. Both commission- and fee-based (fee and commission) planners have an incentive to invest client assets in products which pay the highest commissions. A fee-only structure avoids the significant, inherent conflicts of interest which may arise when an advisor is in a position to gain financially from the purchase of any investment or insurance product recommended to a client.

3. Modern Portfolio Theory (MPT) – Asset Allocation and Portfolio Diversification

Asset allocation is the distribution of investment dollars among various asset classes, such as stocks, bonds, and cash, and the diversification of investments within each of those asset classes. Essentially, this is where the adage "Don't Put All Your Eggs In One Basket" applies.

Research has established that asset allocation is the primary determinant of portfolio Performance (see www.kaloramawealth.com/mission.html). While traditional asset management focuses on predicting individual security price movements, MPT considers the potential for enhancing returns at the portfolio level by combining assets whose expected returns are not highly correlated (don't move in the same direction), thereby reducing portfolio risk or volatility. An investor should invest in a broadly diversified portfolio to ensure obtaining the returns from the top-performing asset classes. This rotation of leadership in the portfolio from one asset class to another enhances the long-term, risk-adjusted performance of the portfolio.

4. Policy Investing – Your Investment Roadmap

Policy investing is derived from MPT and emphasizes financial goal setting, risk reduction, and portfolio diversification. Asset allocation is the key tool for implementing investment policy in a portfolio. An investor's financial goals, time horizon, risk tolerance, and funds available for investment are documented in an Investment Policy Statement (IPS), and then a strategic asset allocation is developed to construct a diversified portfolio which is allocated among many asset classes. An IPS also provides a description of how the portfolio will be constructed and managed, and helps to keep the investor committed as markets rise and fall. It also helps to ensure that the portfolio remains within the investor's stated risk tolerance.

5. Total Portfolio Approach

Most investors have assets in various types of accounts, including taxable, tax-deferred, and tax-free. Assets may also be in different types of retirement accounts, such as Individual Retirement Accounts (IRAs) and employer sponsored retirement plans (401(k) or profit sharing). By considering all assets as one portfolio, an investor is ensured that they are all invested according to the strategic asset allocation plan developed.

6. Efficient Market Hypothesis (EMH)

The EMH states that securities markets quickly and accurately reflect all available information, thereby setting "fair" prices for both buyer and seller. Competition among market participants would make it virtually impossible for any investor to consistently earn a return greater than other investors. Conversely, inefficient markets would enable an astute investor to exploit security prices which do not accurately reflect all available information or do not respond quickly to new information.

Research prepared by The Vanguard Group has shown that some publicly traded securities markets are efficient, but others are not (see www.vanguardeurope.com/international/common/pdf/Art_caseindexing.pdf). In markets which are efficient, over long periods, passively-managed index funds which replicate the performance of the market or an asset class outperform actively-managed funds. Conversely, in markets which are less efficient or inefficient, actively-managed funds which invest by trying to uncover mis-priced securities to buy and sell, in the long run outperform passively-managed index funds. Accordingly, an investor should use a combination of passively-managed index funds and actively-managed funds to maximize after-tax returns.

7. Minimize Investment Costs — Loads, Expenses, and Turnover

Portfolio returns are also affected by various costs, including transaction fees and commissions (loads), as well as operating expenses. Every dollar paid for these costs is one less dollar you have working for you to achieve your goals. The opportunity cost can be significant.

An investor should construct the portfolio by selecting no-load mutual funds and/or exchange-traded funds with low operating expenses and portfolio turnover. The Vanguard research also revealed that average mutual fund performance is inversely related to fund operating expenses. That is, the lower the operating expenses, the higher the average annual total return. Portfolio turnover (how frequently holdings are traded) also influences costs. Higher transaction and management fees are a result of security research, selection, and trading.

8. Minimize Taxes — Asset Location and Opportunity Cost

Most individual investors need to consider a third dimension of investing beyond the two-dimensional risk and return framework provided by MPT. The third dimension is taxation. Every dollar paid in taxes is one less dollar you have working for you. The opportunity cost of paying the tax today must be weighed against future after-tax returns.

Asset location is the process of strategically locating investments in taxable, tax-deferred, or tax-free accounts to achieve the highest level of tax efficiency. Investments are "located" in the appropriate account to defer taxes as long as possible. Generally, tax-efficient investments should be located in taxable accounts and tax-inefficient investments in tax-advantaged accounts.

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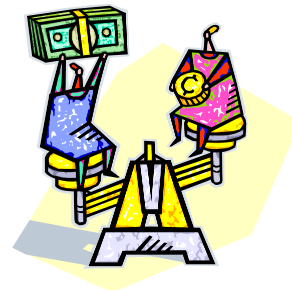
9. Portfolio Rebalancing Forces the "Buy Low, Sell High" Paradigm

Finally, a system for periodically rebalancing the portfolio to maintain the asset allocation strategy documented in an Investment Policy Statement forces an investor to "buy low and sell high." By selling over-weighted or outperforming assets, an investor can use the funds to purchase under-weighted or underperforming assets.



So now we know the "what," "how," and "why" of Portfolio Spring-Cleaning. Whew, perhaps there is much more to this investing thing than you realized!? Perhaps you really do need to hire an advisor? So, how should you go about selecting one? Our next newsletter will discuss the "who" of portfolio management by suggesting criteria you should use to select a financial or investment advisor.

If the investments in your portfolio are unable to answer the question "Why am I here?", Kalorama Wealth Strategies can help you create a plan to invest your assets in a manner providing professional management, diversification, marketability, and liquidity. For more information, please see our web site at www.kaloramawealth.com.

Thank you for your business, trust, and referrals. Please feel free to provide a copy of this newsletter to friends and colleagues who can benefit from information about investing and financial planning. If I can be of any assistance to you or anyone you know, please do not hesitate to contact me.

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