



## **Our Strategy for Investing in Volatile Markets**

This year has presented perhaps the perfect formula for nervousness on the part of investors and managers. Anxiety about markets is not surprising in view of the steady drumbeat of news which has been viewed largely as negative. On the economic front the fallout from the sub-prime lending debacle and the continuing weakness in the housing market have created the most serious credit crisis in decades. In addition, soaring prices in oil and gold have been a constant headline along with concern about the falling dollar. There is also the fear that the economy may be close to recession – this too has become the more obvious debate among economists, strategists and investment managers. Lastly, over the past few weeks, Pakistan has joined the list of areas of the world which have caused geo-political angst. Again, that is what we all see daily, and so is there any doubt there is plenty of – well, doubt?

### **How volatile are the Markets?**

Not really – much of this worry and doubt is borne out by the recent move in measures of volatility in equity markets. The VIX – the Chicago Board Options Exchange Volatility Index is a good example. This index is a weighted average of prices for a range of options on the S&P 500 Index and in general reflects the expected movement in the S&P 500 – a high value of VIX translates into greater degree of market uncertainty, and a lower value the opposite. At the beginning of the year the VIX was trading at about 10, and over the past few days has been trading around 31.

### **What are we doing differently?**

So, in light of all this volatility, are we doing things here very much differently? The short answer is no. We doubt circumstances and the environment for investors are as bad as some of the financial news would have us believe, and equity markets seem to bear this out. U.S. markets are still ahead on the year by about 7% (S&P 500), international markets (EAFE Index) by about 12%, and emerging markets (VWO) up over 40%. **Even if the economic fallout from pressure in credit markets results in a shorter period of negative GDP growth, we would not alter our strategy and philosophy for our clients' investments.**

### **Our Strategy**

That strategy continues to be seeking superior returns with lower risk by diversifying portfolios among multiple asset classes, market sectors and securities. Our philosophy mirrors the tactics practiced by most successful investors, which is the recognition that asset allocation accounts for as much as 90% of performance. The determination of the

appropriate asset allocation is an integral and important step in our investment process. We accomplish this through a series of questions and discussions with each client which quantify subjects such as risk tolerance, income needs, and return expectations over a variety of time horizons. This process is reviewed annually in order to adjust the allocation if necessary.

We attempt to capture performance by using the allocation models developed for the Frank Russell Companies by Sharpe Analytics. These models spread our client's portfolio mix across these asset classes, sectors, and among all size companies for further diversification. The sectors are further diversified by investing in a wide variety of industries and businesses with attractive valuations and characteristics. Our portfolios are designed to have higher yields than the market yet lower P/E ratios and volatility. The resulting mix of assets is one that we can own through good and bad markets with very little turnover.

### **Our Outlook – Things may not be so bad**

It is not clear whether or not the ongoing problems in credit markets will ultimately result in enough weakness in the over-all economy to bring about recession. Let's just say that the likelihood of that has not yet been supported by economic data. Such an eventuality does not seem to be evidenced in wage data, or jobs growth, productivity, the ISM (non-manufacturing business barometer), relative earnings comparisons and the like. Again most estimates of GDP growth are lower for the fourth quarter of this year compared to the second and third quarters, and for some rebound in growth rates in the early part of 2008. The Fed has been tightening for over two years with the express purpose of slowing output to more sustainable levels, and the onset of the sub-prime lending crisis has exacerbated this slowing effect.

The current state of economic activity around the world nevertheless remains very robust. The IMF noted recently that worldwide GDP growth from 2003 through 2007 will be about 4.6% - an impressive feat to say the least. This level of global growth partially explains why the U.S. economy may be able to withstand the weakness in housing and difficulty in credit markets, and avoid some longer period of weakness.

Whatever happens, the fact remains that we are long term investors, and our methodology and philosophy is very risk averse. The current environment with higher levels of volatility, while unsettling from time to time, is not a sufficient reason to alter either our strategy or our longer term investment philosophy.

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November 15, 2007