INVESTMENT COMMENT — August 6, 2007
Update on our Passive, Asset Class Balanced Strategy

Since July 20th – the day after the DJIA closed above 14,000 for the first time – markets for riskier assets have nose-dived. DJIA and other popular stock market indices are down 4.6% to 6.4% in this 14-day period. Balanced portfolios with 60% Stocks / 40% Bonds are also negative. There has been substantial press coverage of the residential real estate and mortgage market problems, primarily loans made to borrowers deemed "sub-prime". The current mood among Wall Street firms is somber. Among mortgage finance and home building companies, it is worse. Some large hedge funds have revealed massive losses. There will almost certainly be more such announcements in the weeks and months to come. *The issue for investors to understand is that this problem has now moved beyond the sub-prime mortgage market, with implications for the broader economy and financial markets.*

Table 1: Passive Portfolios vs. Indexes July 20 – August 3, 2007 Performance	Price 8/3/2007	Return Period	Return YTD	1-Year Risk
Passively-Managed 60/40 Funds				
Vanguard 60/40 Allocation (ticker: VBINX)	$21.54	-3.8%	+2.2%	4.9
DFA 60/40 Allocation (ticker: DGSIX)	$13.02	**-4.3%**	+3.3%	**4.7**
Popular Market Indices				
Dow Jones Industrial Average	13,181.91	-4.6%	+7.4%	8.7
S&P 500 Index	1,433.06	-6.4%	+2.2%	8.0
NASDAQ Composite Index	2,511.25	-5.3%	+10.0%	9.1

Source: *Bloomberg L.P.*
Note: *Returns are calculated inclusive of reinvested dividends.*
Risk is standard deviation of returns.
Index risk and return are calculated using tradeable, index-equivalent ETFs.

To highlight this recent phenomenon, Table 2 shows asset class returns from the current and two most-recent market downturns. All stock market asset class returns were negative and bond market classes positive, with the exception of **HIGH YIELD** and **EMERGING MARKETS** bonds. In each of these periods, investors sold-off riskier investments and replaced them with **US TREASURIES**. A subtle, but important, difference is the negative return of **HIGH YIELD FLOATING-RATE** bonds in the current period. Why? It illustrates a problem in an important bond market sector used by banks to manage the risk of their loan portfolios.

The fund I use as a benchmark for **HIGH YIELD FLOATING-RATE** invests "at least 80% of the fund's assets"[1] in so-called leveraged loans. Such commercial loans are lower-rated debt securities that often have less-restrictive bond terms for the issuer and are frequently used to finance leveraged buy-outs (LBOs) of publicly-traded companies. The pace of LBOs and "going private" transactions has, until recently, created strong demand for publicly-traded stocks. So, what is the link between the leveraged loan and sub-prime mortgage markets? The buyers.

The most prominent investors in the sub-prime mortgage and leveraged loan markets have been "special purpose entities" structured by Wall Street firms to own large pools of such receivables. These investment vehicles, called CLOs (collateralized Loan Obligations) and CDOs (collateralized debt obligations), essentially allow dealers to purchase large quantities of loans or mortgages and, through a process I cynically refer to as "rating-agency arbitrage", they achieve attractive investment-grade ratings on most of the newly-created CLOs and CDOs. These structured investments are subsequently purchased by hedge funds and other institutional investors. To further enhance returns, these investors often leveraged their investment capital 5 to 10 times with borrowed money. Of course, when losses mount or prices decline, those negative effects are also magnified by the same math – and that is where we are now.

CLOs and CDOs are currently being stressed with far greater than projected mortgage delinquencies and foreclosures – and they are not buyers of sub-prime mortgages or leveraged loans in the current environment. Without buyers, such mortgages and loans will not be created – banks will not originate new mortgages and loans without a market to sell them to. In fact, some banks are rumored to hold many such receivables that were "in the pipeline" to be repackaged into CLOs and CDOs.

	Table 2: Asset Class Performance Three Recent Market Downturns	7/20/07-8/3/07	2/26/07-3/14/07	5/10/06-6/13/06
EQUITIES	Large Cap Growth	-5.6%	-4.1%	-7.8%
	Large Cap Core	-6.7%	-4.3%	-7.6%
	Large Cap Value	-7.4%	-4.3%	-7.3%
	Mid Cap Growth	-7.3%	-5.0%	-12.2%
	Mid Cap Core	-7.9%	-4.7%	-10.0%
	Mid Cap Value	-8.4%	-4.4%	-7.8%
	Small Cap Growth	-8.7%	-6.2%	-15.5%
	Small Cap Core	-9.4%	-5.5%	-13.5%
	Small Cap Value	-10.9%	-5.1%	-11.5%
	Large Cap International	-5.5%	-5.1%	-15.5%
	Emerging Markets	-8.7%	-6.0%	-25.4%
ALTS	Real Estate – International	-8.2%	-7.3%	NA
	Real Estate – US REITs	-9.6%	-5.6%	-4.1%
	Commodities	-1.0%	-3.4%	-10.0%
	Hedge Fund of Funds	N/A	NA	NA
BONDS	Treasuries 1-3yr	+0.7%	+0.5%	+0.4%
	Treasuries 7-10yr	+2.0%	+1.0%	+1.3%
	Treasuries 20-30yr	+2.7%	+0.9%	+2.9%
	Treasury IPS (TIPs)	+1.5%	+0.9%	+0.8%
	Mortgage-Backed (MBS)	+1.3%	+0.7%	+0.7%
	Inv Grade Short Duration	+0.7%	+0.7%	+0.5%
	Inv Grade Intermediate	+1.1%	+0.9%	+0.9%
	Inv Grade Long Duration	+1.1%	+0.3%	+1.9%
	High Yield Intermediate	-1.5%	-0.3%	-0.7%
	Municipals Short Duration	+0.4%	+0.5%	+0.4%
	Municipals Intermediate	+0.4%	+0.5%	+0.7%
	Municipals Long Duration	+0.3%	+0.4%	+0.9%
	International	+0.7%	+1.6%	-2.3%
	Emerging Markets	-1.0%	-0.2%	-3.3%
	High Yield Floating-Rate	**-2.3%**	+0.4%	+0.1%
INDEX	S&P 500 ETF	-6.4%	-4.1%	-7.5%
	DJIA ETF	-4.6%	-3.7%	-8.0%
	NASDAQ Composite ETF	-5.3%	-4.6%	-10.6%
	US Domestic Bonds ETF	+0.8%	+0.6%	+0.9%
	US Dollar Index	-0.3%	-0.3%	+2.3%

Source: Bloomberg L.P.
Note: Returns include reinvested

Many market participants are hoping the Federal Reserve will lower short-term interest rates soon. This may happen, but is not likely unless a major financial institution is in peril.

What are the implications for clients?

- *Our client portfolios do not have direct exposure to sub-prime mortgages or leveraged loans.* As described in previous articles and conversations[2], our client bond allocations are primarily US Treasury bonds and High-Grade International bonds.
- Realize that we are in a period of turbulence that is caused by years of complacency – not a discrete, one-time event.

- Where appropriate, we will rebalance portfolios to targeted risk allocations, which means we may purchase/sell asset classes that have declined/out-performed relative to others.
- Appreciate that we are unable to "pick a bottom" or be certain of any near-term movements in any asset class.
- Discuss with me any personal situation that may cause us to realign your overall portfolio risk allocation.
- We design portfolios that, by design, have exposure along the academic risk spectrums of Small – Large and Value – Growth. Note that the riskier factors of Small and Value have been hit much harder in the current sell-off than in the previous two. A quick comparison of the Vanguard and DFA 60/40 funds in Table 1 shows the impact on portfolios with increased "tilt" toward Small and Value. The DFA fund declined 0.5% more than the Vanguard fund that has greater concentration in Large Cap stocks.

For investors employing our passive asset allocation strategy, this is a time to monitor risk allocations and investment performance while keeping an eye on rebalancing opportunities.

[1] Fund Facts from www.fidelity.com website
[2] See, for example, our 2006 Fourth Quarter Asset Class Report