



LITMAN/GREGORY
ASSET MANAGEMENT

Model Portfolio Changes

We are making several changes to our model portfolios this month. We are eliminating our positions in commodity futures and putting the proceeds in PIMCO Developing Local Markets. The short explanation is that we think the increasing economic weakness combined with the strong run up in commodity prices in recent months outweighs the longer-term diversification benefits of owning commodity futures at this time. A more detailed discussion of this move is included later in this commentary.

This month we are replacing all or the majority of TCW Select Equities (TCW) from our portfolios. In February 2008, Craig Blum was appointed the sole portfolio manager of the fund. Blum had been co-portfolio manager with Steve Burlingame, who unexpectedly resigned, which led us to re-evaluate our opinion of the fund. Although we continue to think highly of Blum, Burlingame's departure raises a handful of questions that in our opinion will take some time to resolve. Collectively, these questions create some uncertainty and weaken our confidence in the fund. Therefore, we are replacing TCW with higher-conviction alternatives. In the Capital Preservation and Balanced Income profiles we are making a one-for-one swap out of TCW and into Touchstone Sands Capital Select Growth

Fund (PTSGX). In the remaining four profiles, the large-cap growth allocation, all of which is currently in TCW, is of sufficient size that we can use two to three managers. This is our preference, provided we have high conviction in each manager. Because we are close to completing ongoing due diligence on another manager who we believe will likely clear this hurdle, we are selling roughly half of our TCW position in favor of Touchstone Sands, with a smaller percentage going to Turner Concentrated Growth (TTOPX) in our two most-aggressive profiles. We are postponing a complete sale of TCW until we finalize our due diligence on the third manager. If our final opinion of this manager is

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not sufficiently high, we will sell the rest of TCW, and will likely allocate the funds to some combination of Touchstone Sands and Turner.

Our Investment Views

In the 2001 Berkshire Hathaway Annual Shareholder Report, Warren Buffet wrote "you only find out who is swimming naked when the tide goes out." Well the tide has gone out and it's not a pretty sight. Though we wore our swim suits, we did not fully appreciate the economic risks that have become apparent. We have often said that accurate economic forecasting is difficult and therefore we rely on valuation work and scenario analysis as the basis for investment decisions. That approach has been helpful to us in this

environment but it's likely that we are not yet out of the woods. There were a small handful of observers who saw this coming and here we must credit Bob Rodriguez of FPA Capital who not only foresaw much of what has happened, but even wrote and spoke publicly about it months before the credit markets became dysfunctional. In terms of stock market prices, it is likely but not certain that we are now closer to the end than the beginning of the bear market, though more downside remains very possible.

Through this very tough environment our portfolios have performed with our Standard Profiles 1-6 outperforming all Strategists in 2007.

Year-to-date through 2/29/2008, our Standard Profiles 1 and 2 portfolios have been the top-performing models among the Strategists as well as our Enhanced

Fund Index Models 3 and 4. Our strong relative performance is mostly attributable to our successful tactical asset class moves over the past couple of years including our large-cap U.S. stock overweight (and U.S. small-cap underweight) and our allocations to Commodity Futures and Developing Market Short-term Bonds in our balanced models.

This quarter we've chosen to communicate with you in a Q&A format because we believe it is the most reader friendly and efficient way to explain our thinking on a range of sometimes complex topics, not all of which will be of interest to all readers.

The Economy

What is your view of the U.S. economy? Though the label is unimportant, it's probable that we are already in a recession or on the verge of entering one. It's clear that the severely troubled housing and credit markets are beginning to have an impact on the health of the overall economy. The worst phase of the credit market problems could last for several more months, and the housing problems could continue into 2009. High energy costs don't help but are not the primary concern. The problems facing the economy are clear:

- **Housing:** The housing market is in the worst downturn since the 1930s and the evidence strongly suggests there is still a ways to go. The Fed has not been successful in materially lowering mortgage rates, though actions since the Bear Stearns collapse have had some positive impact. And while home affordability is improving as home prices decline, there is still a massive backlog of unsold homes. Adding to that inventory will be waves of foreclosed properties that could continue into 2009. It could take a year or longer to get inventory levels back to normal. The weakness in the housing market reduces wealth and spending, increases unemployment, and continues to contribute to dysfunctional credit markets.
- **Dysfunctional Credit Markets:** Despite the efforts of the Fed,

credit markets are not functioning properly. Sizable losses on subprime loans have lowered the capital base of many financial institutions. The situation is exacerbated by a financial system that has, over a period of years, become intertwined in a spaghetti-like fashion through the spread of complex financial products (CDOs, CLOs, CDSs, and the like). This complexity makes it difficult to clearly understand what assets may be at risk, and also, how big those risks may be. This uncertainty has led financial institutions to retrench, which in turn makes credit (loans) more ex-

The emerging markets are in better shape with increased trade with each other, growing consumption, in some cases significant planned and self-funded infrastructure investment (China), and (somewhat ironically) stronger balance sheets.

pensive and less available—even while the Fed tries to make credit less expensive and more available. But financial institutions are in self-preservation mode, protecting their own balance sheets and hoarding liquidity against known and unknown losses to come, not just in subprime but in leveraged loans (loans made to private equity investors), credit cards, auto, and business loans. This, in turn, is causing serious problems for entities who borrowed on a short-term basis and who now can't get new loans at reasonable prices (or at all) to replace their maturing loans. They then have to sell assets to pay off their ma-

turing loans and they often start by selling their highest-quality assets because these are the easiest to sell. One example of this dynamic is the weakness in the tax-exempt bond market as a number of leveraged hedge funds lost on bets that muni bonds would outperform Treasuries, got margin calls, and had no choice but to sell them.

The bottom line is that credit markets are not functioning properly at present. There is an adverse feedback loop in play with losses impairing financial institutions' capital, which reinforces tight lending and asset sales to reduce leverage, which harms the economy and triggers more losses and so on. The ability to borrow money at a reasonable cost to support consumer spending and conduct business is essential for a healthy economy. Perhaps even more important to a stable economy is the ability to refinance maturing debt. The longer the problem lasts, the more damage there will be to the economy.

- **Labor Market and Consumer Spending:** Not surprisingly, we are now beginning to see a clear weakening in employment and consumer spending, though not at levels that indicate a recession—at least not yet. Continued deterioration in the labor market could feed back to trigger more defaults as people have a harder time servicing their debts. This could delay recovery in the housing and credit markets and

become a self-reinforcing cycle. Meanwhile, declining consumer spending will impact corporate profits.

It is also worth noting that while most of the rest of the world is doing better than the U.S., Japan's economy is also struggling and Europe's is slowing. It seems likely that most of the developed world will continue to weaken. The emerging markets are in better shape with increased trade with each other, growing consumption, in some cases significant planned and self-funded infrastructure investment (China), and (somewhat ironically) stronger balance sheets. However, we don't expect them to be fully immune from economic weakness in the developed world.

How bad could the economy get in the near term?

It is always hard to say. In many ways some of the variables in play are similar to 1990-91 when there was a severe downturn in commercial real estate (some called it a real estate depression), war in the Middle East, a sharp spike in oil prices, and the S&L crisis. Consumer spending declined during that recession, unlike the 2000-02 recession, which was driven by a big drop in corporate activity. Overall, the 1990-91 recession lasted eight months and unemployment rose above 7%. Clearly there are similarities between then and now. Optimists point out that the Fed is responding more aggressively this time around and that the magnitude of financial sector write-offs (at least so far) was worse back then. Moreover, export growth

is particularly strong now. However, the credit market problems are clearly worse this time around and that makes this potential downturn much more worrisome. The backdrop isn't comforting. There is much more debt relative to the size of the economy now and financial instruments are far more complex, making it difficult for even the financial institutions that hold them to assess the extent of the problem. This suggests that the economy has the potential to suffer a longer- and deeper-than-average recession. (The average post-WWII recession has lasted 10 months with a range of six to 16 months. Most have been clustered between eight and 11 months.)

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There are always positives. What are they? As mentioned, the biggest positive for the economy in the near term is the aggressive, and in some respects, unprecedented action of the Federal Reserve. Though the Fed's moves have not been as effective as they would like, they have made it clear that they will do what it takes to stop a major downturn and they still have weapons in their arsenal, such as directly buying mortgage securities in the public market. Recent actions, such as the establishment of the Primary Dealer Credit Facility, strike us as significant. The facility allows security dealers, such as Goldman Sachs, Lehman Brothers, and Morgan Stanley, to borrow directly from the

Fed at a very low interest rate (currently 25 basis points above the federal funds rate) using a wide range of collateral, including investments that have been hard to sell in the current market environment.

The dollar's weakness has also significantly improved the competitiveness of U.S. businesses versus foreign competitors. As long as the dollar either stabilizes or gradually declines, as opposed to crashing (which we continue to view as quite unlikely), this should stimulate demand for U.S. goods. Export strength is already happening with exports contributing a significant one percentage point to economic growth over the last six quarters (annual rate). This almost offset the economic impact thus far of the housing downturn. One caveat: exports will grow provided the global economy doesn't weaken so

much so as to offset the market share increase. At this point this looks like a good assumption relative to the emerging markets but is less of a sure thing with the developed world.

Finally, outside of the financial sector, companies are generally flush with cash, especially relative to debt-service needs. Balance-sheet strength is surprisingly healthy for this late in an economic cycle—the result of strong profit growth and below-average capital investment in recent years. According to Bridgewater (a research firm and institutional money manager), the number of companies that may struggle to service their debt is at the lowest level ever (in this case the data goes back to 1970).

Weighing the evidence, the odds seem somewhat skewed towards a worse-than-average recession but that outcome is far from inevitable.

Do today's economic stresses have any longer-term economic ramifications?

There are two potential long-term ramifications. First, as the Fed and policy makers attempt to break the adverse feedback loop, the amount of stimulus that is being required increases the potential for higher inflation down the road—not 1970s style inflation, but more than we've been accustomed to. Inflation is unlikely to be a near-term problem because a deleveraging (debt reduction) and a recessionary environment is deflationary not inflationary. But longer-term, the increased supply of dollars has to go somewhere and that raises the risk of inflation. It also undermines the dollar's value relative to other currencies. That's also inflationary as imported goods cost more. The second ramification is the likelihood of continued deleveraging on the part of households for several years, resulting in slower credit growth (less borrowing) in the next recovery. If consumers borrow less and spend less, economic growth and corporate earnings growth will be slower than they would otherwise be. All this raises the risk of some stagflation in the next economic cycle.

Assessing Market and Portfolio Risk

How does this down market compare with past stock market

downturns? Though it might not feel that way, so far the stock market decline has been milder than the average post WWII cyclical downturn of 26% and a median loss of 20%. In the worst declines there was typically a confluence of contributing factors, including overvaluation. As of this writing the low point for the S&P was on March 10, when it was 19% below the October 2007 high. The small-cap Russell 2000 Index also hit its low on March 10, 25% below its 2007 peak.

Post-WWII Cyclical Bear Markets	
S&P 500 Declined:	Number of Declines
Between 10% and 20%	4 times

The dollar's weakness has also significantly improved the competitiveness of U.S. businesses versus foreign competitors.

Between 20% and 30%	3 times
Between 30% and 40%	1 time
Between 40% and 50%	2 times

What is the risk from here in the markets? As you know we don't count on our ability (or anyone else's) to forecast the economy. Instead we consider a variety of plausible scenarios and stress test our portfolios against these scenarios. As we consider the risks to the economy the biggest concern is that the Fed is not able to disrupt the adverse feedback loop described earlier in time to avert increased economic damage. If the pattern of more debt defaults and falling asset prices goes on for too long, financial institutions will weaken further and the economic downturn could be deeper and longer than any

we've experienced in quite some time. The more likely scenario is that the Fed's efforts, which go well beyond simply lowering interest rates, will be successful and that the U.S. will avoid a really bad recession, though a slower than normal recovery with slower corporate earnings growth could still be likely. The Fed's recent moves are unprecedented and make clear their level of concern. However, we are cognizant that this more "optimistic" scenario is not a sure thing and that there are risks that are difficult to analyze, particularly the massive amount of unregulated, complex, and opaque structured financial products (e.g., credit default swaps).

Despite the decline already experienced, at its current level (S&P 500 at 1330), we don't believe the stock market is pricing in a bad recession. At most it may

be pricing in a slowdown or perhaps a mild recession. There seems to be a consensus developing that the economy will recover later in 2008 and for that reason stocks should begin to rebound soon. This view is reflected in healthy corporate earnings forecasts for the last half of the year. We believe this scenario is likely to be overly optimistic given our understanding of the outlook for housing over the next year (expected foreclosures, huge inventory of unsold homes, and further price declines), other losses on debt instruments, and the continued impact on financial institutions.

It would take a decline of another 10% (with the S&P 500 down to around 1200) before stocks would be priced at a level that would be very attractive

relative to fixed income alternatives and reasonably attractive on an absolute return basis in most scenarios. However, in the bad recession scenario stocks could fall as much as another 20% below the recent low—maybe even more. That would be a truly bad bear market—not as bad as 2000-2002, but bad enough to qualify as the third-worst market decline since 1950. (Other equity-oriented asset classes are discussed later.)

In contrast to equities, bonds are clearly pricing in a recession. The 13-week T-bill hit a 50-year low on March 20 at less than 0.50% annualized yield. The fact that investors were willing to lend to the U.S. Treasury for three months for practically no return shows the degree of their risk aversion. Two-year Treasuries were briefly yielding less than 1.5% on the same day. Conversely, rates on just about any other fixed-income instruments were sharply higher. Even high-grade long-term tax-exempt bonds were yielding more than comparable maturity Treasuries. And junk bonds were selling at recession-level yields of over 11%—though not all this yield will be captured as the default rate rises.

How do the risks translate at the portfolio level? Our risk-management objectives are to seek to avoid violating the one-year risk thresholds set for each model. We chose one year because we felt this was a short enough period to be sensitive to most clients' risk tolerance but not so short that it would significantly

limit our ability to add value via our long-term, fundamentals- and valuation-driven investment approach. The time horizon is important because bear market declines don't always last more than 12 months—so there are periods of positive returns during any 12-month period that offset a portion of the negative returns. However, this is not always true and the worst bear markets can last over a year. There was one bear market since 1950 that lasted more than two years (the 2000 to 2002 period) and there have been two others that lasted almost two years (1973-74 and 1981-82).

In building portfolios that will maximize long-term returns while being

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sensitive to risk, we stress test portfolios for significant-risk scenarios, but we do not manage to the most extreme-risk scenarios. Because these scenarios are so rare, managing to that level of risk would require giving up a significant amount of long-term returns. In our 21-year history, we have experienced one extreme-risk environment during the bear market earlier this decade. In that environment, our balanced portfolio neutral benchmarks did violate risk thresholds. So far in this bear market we are still above our risk thresholds, though not by much. If stock markets fall further and stay lower through coming quarters, it is likely that we will exceed our risk thresholds in at least

some portfolios.

This risk could be further increased (or possibly decreased) if we tactically overweight equities. For example, if stocks drop another 10% it is likely that we will begin to increase equity exposure. Because we don't expect to be lucky enough to pick a bottom, it is likely that stocks will continue to decline from that level before reversing. So in the short term, taking on more stock market exposure also exposes portfolios to more risk. The positive to focus on in that situation is that we would be buying into stocks at a level that we believe reflects very good value and should result in strong long-term returns relative to more conservative investment options.

Given the risks, why not reduce exposure to stocks? We are not reducing stock market

exposure because, in spite of the risks, we view stocks as priced to out-return bonds under most five-year scenarios. In the past few months we have spent many hours updating our valuation work including careful analysis of a variety of earnings growth and inflation/interest rate scenarios. This work has included incorporating new valuation metrics that factor in expected return premiums for stocks versus bonds. Our work resulted in a slight reduction in our expected returns for stocks. However, stocks are attractively valued relative to bonds, and within about 10% of triggering a tactical opportunity. Our conclusion is helped by low expected returns for investment-grade bonds (we expect bonds to return around 4% or less

over the next five years).

The bottom line is that we don't believe stocks should be sold now in spite of near-term risks. Supporting this view:

- Stocks are down 15% from their peak as we write this in late March (and as noted, were down by as much as 19%). In six of the eight 20% or greater market declines since 1950, stocks delivered strong, double-digit annualized returns over the following three years. The two times that did not happen were in the secular bear markets in 1973-74 and earlier this decade.
- The Fed has clearly indicated it will do everything within its power to avoid the scary scenario of an out-of-control debt-deleveraging cycle. Congress may also enact policies that may help to support the housing market.
- Markets are forward looking not backward looking. This is why stocks almost always start to rebound months before the end of a recession. If we are already in a recession, stocks will probably begin to rebound later this year, possibly soon. It is possible that they have already bottomed.
- A number of stock pickers we respect are encouraged by current stock-picking opportunities. This view is not universal, but it is more common than not. Among the very bullish, some are exactly perennial optimists.

- The stock market has already struggled for a long period of time and remains below its early 2000 peak. Over the past ten years the S&P 500 has only averaged about 4% per year, reinforcing our assessment that stocks are at least fairly valued.

One risk that investors face in market declines is the risk of whipsaw—selling into market weakness and ultimately buying back into the market at higher prices. Having already experienced a considerable price decline, we don't want to have a smaller weighting to stocks during a market rebound than we held during the decline. If we knew that stocks were headed for a much

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bigger fall we would reduce exposure. But we don't know that and again, they are already priced to beat bonds or cash in most five-year scenarios. If stocks do have much further to fall, our various balanced portfolios have other assets to help cushion that decline. And lower prices ultimately suggest higher returns down the road.

Our discipline in environments with significant macro risks that are hard to analyze is critically important—we are falling back on our valuation analysis, scenario analysis, and our long-term investment horizon and weighing all these factors to help us understand the short and longer-term risk/return trade-offs.

Some investors say stocks are clearly cheap based on P/E multiples and interest rates. Why don't you agree? We look at stock valuations on a forward-looking basis. Looking ahead, we believe that earnings forecasts are still overly optimistic and are likely to come down. So the "E" is too high. And looking out over our time horizon, we believe it is very likely that interest rates will rise, probably by a material margin. At that point, the comparison with interest rates will be more demanding, probably suppressing the P/E multiple. So while we believe stock values are getting attractive, we don't believe they are at fat-pitch levels.

What are the ramifications of a possible stagflation-type environment in the next economic cycle? The

answer is partly dependent on how bad the environment is. At this point we believe it is very unlikely that we will see double-digit, 1970s-level inflation. We've modeled a stagflation scenario characterized by a five-year inflation-adjusted earnings decline from the 2007 earnings peak that is on par with some of the worst in decades. We've coupled this earnings outlook with a moderate P/E multiple. In this scenario stocks return only 3% annually from current levels—similar to bond returns. Obviously, this would be a very negative scenario and its possibility is one reason we have exposure to foreign currencies (and would likely own commodities), which would likely do better in this type of environment. Though stagflation is not the im-

mediate concern, it is a longer-term possibility that has us thinking about different potential asset class mixes at some point.

Other Asset Classes

With the flight-to-safety-driven rally in U.S. Treasury bonds, are there good values in other areas of the bond market?

Treasuries clearly don't offer compelling long-term value at present. With 10-year Treasuries yielding only 3.47% on March 28, investors are not likely to be left with much return after inflation. Other bond sectors look considerably more attractive. In fact most other sectors including agency mortgaged-back securities, investment-grade corporate bonds, and tax-exempt bonds offer compelling yields

compared to Treasuries.

The problem is that Treasury yields are so low that the appeal of

other bond sectors is mostly relative rather than absolute. Still, 20-year tax-exempt bond yields not much below 5% aren't too bad. And for tax-exempt investors, agency mortgage-backed bond yields that are well into the 5% range also are not too bad. (Recently, PIMCO Total Return, our core bond holding, had about 60% of its portfolio in agency mortgage-backed securities.) But while bond managers talk about the best opportunities in 20 or 30 years, it is important to realize that they are talking in relative terms. It is nothing like the early 1980s when investors could lock in yields on high-quality bonds in the teens. Nobody is going to get rich off of 5% bond yields, but in a low-return world these yields are not bad.

High-yield bonds, on the other hand, probably will offer yields that will be extremely compelling before the end of this cycle. Yields are now over 11% and will probably go higher if the recession is average or worse. Dr. Edward Altman of the NYU Stern School of Business, and a prominent high-yield market researcher, believes a slew of lowly rated bonds issued earlier in this decade suggest default rates in the high-yield universe could hit 16% if we experience a recession comparable to 1990. With the passage of time, when the coming spike in defaults is nearer to its peak, expected returns are likely to be compelling. We'll be watching closely (and expect to be acting at some point).

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What is going on with the municipal bond market? Why have returns been so much lower than Treasuries? The problems were initially triggered by credit problems with the firms that insure some tax-exempt bond issues (e.g., MBIA and Ambac). These "monoline insurance" firms have traditionally insured tax-exempt bonds, which rarely default. However, in recent years, the monoline firms began insuring structured debt, such as CDOs, that turned out to be much riskier than they expected. Rising defaults and uncertainty about the magnitude of potential defaults from structured debt has put the insurers' credit ratings at risk. This in turn puts the credit ratings of the underlying bonds they insure at risk. Consequently, most insured bonds, which

are typically A or AA rated on their own, now trade as if the insurance didn't exist. This means their prices have fallen (and yields have risen) from the level of an AAA issue to that of an A- or AA-rated issue.

In a related development, a little known but significant part of the market, auction-rate securities, has shut down and forced some issuers to issue new longer-term bonds in their place. This has pushed more supply into the market. On top of that, a number of hedge funds had bet that tax-exempt bonds would outperform Treasuries (mentioned earlier)—in recent months that has been a costly bet and one that resulted in margin calls for many hedge funds (and this at a

time when hedge funds' brokers have been raising margin requirements in general). This has resulted in waves

of forced selling, further pressuring the market. All of these problems are likely to pass and are not reflective of the underlying credits. However, in a deep-recession scenario credit risk is likely to be somewhat higher than tax-exempt bond investors are used to. Some tax-exempt issuers that rely heavily on property taxes or sales taxes may default. We believe bonds are already priced to reflect these risks. Tax-exempts are likely to outperform comparable maturity, taxable benchmarks over the next year. (Actively managed taxable funds could also do well compared to benchmarks given the relative values in agency mortgaged back bonds and corporates.)

Does Litman/Gregory still find emerging-markets local-currency

bonds compelling? Yes. This asset class has performed well since we first established a position in late 2005. Our views haven't changed. We continue to like the combination of a decent yield (over 6%) and potential for more currency appreciation. We believe the case remains compelling for dollar depreciation against many emerging market currencies and Asian currencies in particular. The case is supported by trade surpluses that many have with the U.S., emerging markets' generally stronger economic growth, their (generally) sizable currency reserves, and the likelihood that many of these countries (led by China) will find it increasingly in their best interest to allow their currencies

to appreciate in order to reduce inflation pressures in their domestic economies. Importantly, our exposure to developing market currencies also provides

our portfolios with some inflation hedge as a depreciating dollar is associated with rising pressure on the prices of commodities and imports. (As an aside, the fundamental case for continued dollar weakness against developed-market currencies is no longer convincing though fundamentals may not matter in the short-term.)

REITs have been suffering through a deep bear market for about a year, aren't they cheap yet? At their low point earlier this year REITs were down well over 30% from their 2007 peak (this takes into account dividends). However, prior to this point REITs were overvalued. We are in the process of updating our REIT valuation work and developing new metrics. At present we view REITs

as fairly valued. However, the more optimistic growth assumptions often put forth by REIT managers support a more bullish view for REITs. We are in the process of examining these growth forecasts. In the near term it seems likely that prices will decline in the property market—however, the public REIT market is already priced to take into account significant price declines.

What about foreign stocks? Isn't the rest of the world in better shape?

Generally, the rest of the world is in better shape though Japan and Europe are both weakening and may also experience an economic downturn. Emerging markets are in better

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shape, as mentioned earlier, but will feel some impact of a slowdown in the rest of the world. The other side of the equation is valuation, and after a very strong multi-year run of relative performance foreign markets are generally not undervalued relative to the U.S. By some metrics many look overvalued, though we still put them in a broadly fair-value range. With respect to the impact of currency on return, as mentioned earlier, we believe many emerging markets still have more currency tailwind to come. However, there is an increasing chance that the dollar's decline versus many developed market currencies (e.g. euro, pound and yen) is nearing its end and could reverse over time. This could result in a return headwind for U.S. investors.

Until very recently, commodity futures were moving sharply higher.

Is it time to take profits? Our position in commodity futures has added considerable value since we established it in early 2005 and we continue to believe they offer important long-term diversification benefits. However, in recent months, the asset class has spiked sharply higher, and we think it may currently reflect some speculative excess beyond the underlying supply/demand fundamentals. Additionally, the risk of a significant slowdown in the economy has increased, and commodity futures would likely do very poorly in a deep-recession scenario. While commodity futures would benefit our portfolios in a rising inflation

or stagflation scenario, we believe the current negatives are more significant, and for that reason we are eliminating our commodity futures positions.

We are reallocating the proceeds to PIMCO Developing Local Markets (DLM). This continues to provide us with some of the protection of commodity futures in the event of continued inflation driven by dollar weakness, and, as with commodity prices, benefits from the continued growth/relative strength of emerging markets. We won't get as much downside protection in DLM as we would with domestic investment-grade bonds (via PIMCO Total Return) but we expect to get considerably more than we had with commodities.

Looking longer term, our research shows that in most environments commodity futures are likely to add value to our balanced portfolios, and

so in the future we expect to reintroduce them to our portfolios.

Investment Strategy

How would you summarize Litman/Gregory's current investment posture?

- We continue to have a neutral level of equity exposure; however our U.S. equity exposure is overweighted to larger companies and underweighted to smaller companies based on relative valuations and economic-cycle factors.
- We continue to hold a portion of our fixed-income exposure in local-currency emerging-markets bonds.

What investment moves is Litman/Gregory considering?

We plan to increase exposure to large-cap stocks by 5% if the market drops about 10% below its current level (we continue to view large-caps as offering better value than small-caps). Our plan is to buy an S&P 500 index fund or large-cap U.S. stock fund by taking 2% from our investment-grade bond exposure and 3% from our local-currency emerging-markets bonds. In the event that stocks continue declining beyond that point, we have identified the market levels at which we would make additional tactical purchases of equities. This is an important part of our discipline that helps to ensure that we will not hesitate when presented with good long-term opportunities in the face of what would be a very negative immediate stock market environment. It is also possible that we will have tactical opportunities in areas such as REITs, high-yield bonds, and emerg-

ing-markets equities. If this happens, we expect to adjust our strategy to allow for exposure to multiple opportunities.

Comments on Specific Investments

A few of your equity managers you use have struggled, are you concerned? We are not happy with the performance of a few of our equity managers. The worst over the past few years have been Bill Nygren (Oakmark) and Chris Davis and Ken Feinberg (Selected American Shares and Clipper fund). While these managers are underperforming their benchmarks, we know that all managers experience occasional periods of underperformance (see our Man-

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ager Study posted to the AssetMark website).

We always monitor the performance of our managers, but in light of the recent performance we have increased our contact and reassessed our conviction level. During this period we've had detailed discussion about stocks that have underperformed, reassessed the stockpickers' investment process and team, and revisited the reasons for our confidence. We realize underperformance is frustrating and we don't hesitate to fire managers if we have good reasons for losing confidence. But we also know that skilled managers can (and often do) experience strong performance rebounds coming off of poor performance periods. So the question we must ask is whether

recent periods of sub-par performance are likely to continue or likely to reverse, over our time horizon. At this time we don't believe any changes are justified other than our removal of TCW Select Equities due to the manager change at the fund.

Closing Comments

As we write this, market volatility continues. However, we suspect this will continue to be one of the most challenging investment environments we've ever faced, at least for a while. We believe investors may still be underestimating the losses yet to be written off by the financial sector and the resulting economic ripple effects. But stocks are reasonably valued now, and if they fall much further, it will

represent an attractive buying opportunity for long-term investors. And while we believe it is important for us to discuss the more nega-

tive possibilities, we reiterate that it is possible that we are close to a bottom, or that we have already reached a bottom. We can't know what the near-term is going to bring, but at times like this when economic uncertainty is high, our discipline and research process keep us grounded and give us confidence in our ability to make sound long-term decisions.

Litman/Gregory Style Analysis Graph

