



UNDERVALUED SECTORS

(CONSIDER!)

- MEDIA
- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- COMMUNICATION EQUIP.

OVERVALUED SECTORS

(AVOID!)

- JUNK BONDS
- EMERGING MARKETS
- MONEY CENTER BANKS
- REITS

I Bet You Think This Song Is About You...

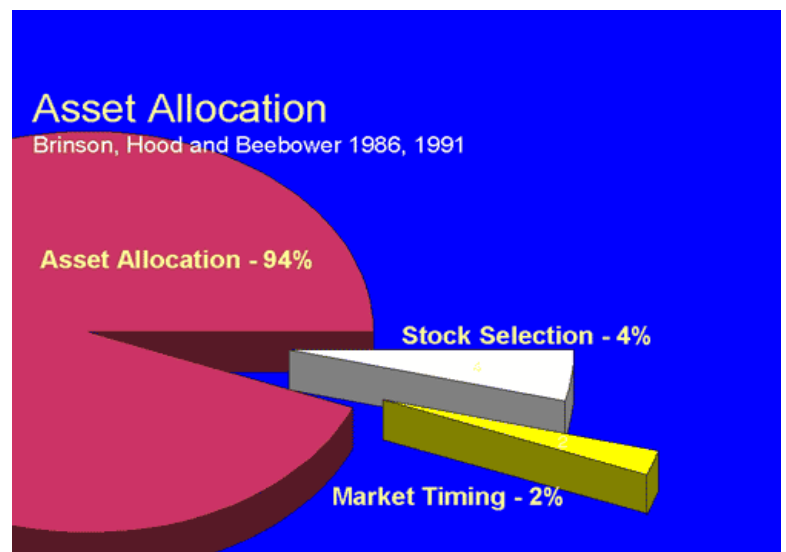
Studies show that in well-diversified portfolios, the asset allocation decision constitutes 85% to 90% or more of investment performance. Yet, it has been our experience that 85% to 90% of most investors' time is spent on the 10 – 15% of individual issue analysis and not on the more performance determinant asset allocation decision. Why do most investors spend the vast majority of their time digging into the details of individual companies and not on the larger, more significant portfolio-wide decision process?

In the landmark study, "Determinants of Portfolio Performance," published in the Financial Analysts Journal (July-August 1986), Gary P. Brinson, L. Randolph Hood, and Gilbert Beebower examined the investment results of 91 very large pension funds to determine how and why their results differed. They reasoned that only four elements contributed to investment results: asset allocation, individual security selection, market timing, and costs. By using a rather straightforward regression analysis, they were able to attribute the contribution (or lack of it) of each of the four elements.

Asset allocation was defined as the average base commitment to three asset classes: stocks, bonds, and cash. For instance, a pension fund might have a mix of 60 percent stocks, 30 percent bonds, and 10 percent cash.

Market timing was then determined by variations around the base commitments. If a pension fund changed its commitment to the three asset classes over time, it was assumed to be an attempt to profit from market timing.

The conclusions were remarkable. Using market-index returns for the three asset classes- S&P 500 for stocks, Shearson Lehman Government/ Corporate Bond Index for bonds, and the 30-day Treasury Bill for cash- the team was able to explain 93.6 percent of a pension fund's performance based solely on knowing its investment policy! The biggest single factor explaining performance was simply the investment policy (asset allocation) decision that determined how much a fund should hold in stocks, bonds, or cash.



365 S. Rancho Santa Fe Rd., Suite 300, San Marcos, CA 92078

www.centurioncounsel.com ~ info@centurioncounsel.com

(800) 878-8536



I Bet You Think This Song Is About You...

(continued)

“It’s a market of stocks and not a stock market,” or so the saying goes. However, if the asset allocation trumps the individual stock selection process, then doesn’t it behoove investors to spend more time on identifying and understanding the macro picture than dwelling on the details of the individual issues? Moreover, isn’t it fair to say that far too many resources are expended in the area of the specific and too few resources are spent on the larger, more significant environment?

For investment strategy purposes, the value in focusing on individual issues rests in the insights they can provide to the larger context. To be sure, there is value in getting “down in the trenches.” However, when *trench warfare* is the dominant focus of investors, then getting “lost in the forest for the trees” is the more apt phrase. That, unfortunately, is where many investors find themselves. In a globalized world, an opportunity exists for those who can widen the lens and understand the larger context. This is a world where context is king.

No-Fault REDUX

We have written about no fault-capitalism several times in the past. Once again, the Federal Reserve and the markets have a chance to let capitalism do what it does best, or they can reward fools and risk takers. The former course will cause some pain in the economy but will be the best in the long run.

What will be the impact from the sub-prime mortgage problem and the *yen carry trade*? Is there a connection between them and the economy? Bubbles have consequences far beyond their causes when they burst. That is, because they encourage irrational behavior and risk taking, not just in the asset that is rising in price, but also in surrounding areas. As an example, remember the internet bubble? There were 350 internet stocks at the end of 1999, comprising a mere 6% of the market cap of total US equities. But the NASDAQ dropped by over 70%. The damage was not confined to just internet stocks.

What began as a reasonable response to lower rates (higher home values) evolved into a mad chase to cash in on what seemed like a market that would rise forever. As we now know, loans were made that were simply not economic, some even fraudulent in nature.

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365 S. Rancho Santa Fe Rd., Suite 300, San Marcos, CA 92078

www.centurioncounsel.com ~ info@centurioncounsel.com

800-878-8536



No-Fault REDUX (continued)

The argument is made that this is just a small part of the housing market. The damage will just be in the sub-prime world and will not spread to the rest of the economy. And then we throw in a problem from over the Pacific called the *yen carry trade*, and there is the potential for a world where risk is on the rise, and risk premiums will rise as well.

Sub-prime mortgages were about 20% of the market in 2005-2006. Already, almost 12% of those mortgages are in some part of the foreclosure process, with anecdotal evidence that the number is going to increase. The prediction late last year by the Center for Responsible Lending (CRL) that as many as 20% of the sub-prime loans made in the last two years would end in foreclosure does not look as farfetched as when it first was made. The CRL study suggests that as many as 2.2 million people will lose their homes.

If you put just 4% (and it could be more) of the homes sold in the last two years back on the market within the next six months, it is going to have a serious effect on housing valuations. Lenders are not in the rental housing business. They can hold on for a little while, but eventually they are going to have to "bite the bullet" and sell; and that means offering a discount. Discounted homes mean that appraisal values are going to drop in that area.

The argument is that this is just the sub-prime and lower end of the market, and that the rest of the housing market will not be affected. Why are we seeing the explosion in defaults and foreclosures? This note from CBS News gives us at least part of the answer:

"Today, about 80 percent of sub-prime mortgages are adjustable-rate mortgages, or ARMs, also called 'exploding ARMs.' These loans are so named because they carry low teaser rates that often reset dramatically higher, thus increasing the borrower's monthly mortgage payments by 25 percent or more.

According to reports from loan counseling agencies across the nation, the main reason homeowners give for falling behind on their mortgage payments is not a change in personal circumstances (such as a job loss), but instead, they are not able to make the increased payments on their ARMs.

The loan application and review process for 'no-doc' loans was so lax that such loans are referred to as 'liar loans.' In a recent report by Mortgage Asset Research Institute, of the 100 loans surveyed for which borrowers merely stated their incomes on loan documents, IRS documents obtained indicated that 60 percent of these borrowers overstated their incomes by more than half.



No-Fault REDUX (continued)

The newer mortgage products, such as 'piggyback,' 'liar loans,' and 'no doc loans' accounted for 47 percent of total loans issued last year. At the start of the decade, there were estimated to be less than two percent of total mortgage loans. As a result, homeowners have never been more leveraged. The average amount of debt as a percentage of a property's value has increased to 86.5 percent in 2006 from 78 percent in 2000."

This means that almost 50% of the loans made last year were made with little or no documentation check, and 60% of those people overstated their incomes by more than half!!! That means 30% of the loans made were to people who were stretching to buy a home and whose actual income would not qualify them for a home anywhere close to what they bought.

Furthermore, on another side of the world, the *yen carry trade* is taken off the table, thus drying up liquidity. Being over simplistic, you can borrow yen (or if you are Japanese, invest yen abroad) at 1%. If you invest in funds or assets that pay more than that, with or without hedging costs, you can leverage up and make a nice differential "carry." You can invest in 5% U.S. treasuries, 7% corporate bonds, stocks, emerging-market debt, soybeans or cattle futures... whatever you have the stomach for. So, as long as the currency is stable, or the yen is falling, you are in good shape. But if the yen rises, your return falls, because when you sell whatever asset you purchased, you now owe more yen back.

If you borrow 121.9 yen to buy a dollar's worth of U.S. Treasuries, and the dollar falls to 115.8 yen, you now have lost almost 5% in one month. If you are levered two, three, or more times, you can get hurt quickly. When you sell your asset to get dollars to buy Yen to pay back your loan, you get only 115 yen and you owe 122 plus interest. Suddenly that cheap interest rate hurts.

There is a growing call for the Federal Reserve to cut rates to help the housing market and protect the carry trade. Congress is getting into the mix with continued *noise* coming from government officials (House, Senate and States-- all with different solutions) regarding the government injecting funds into the sub-prime market (allowing people with untenable mortgages to refinance at more reasonable rates with the government footing the bill). If either of them "help" to "ease the pain," the message will again be sent that taking risk is "not a problem because the government will bail you out." We need to let investors, lenders and speculators fail and be responsible for their actions.