Walker & Associates

Walker & Associates Investment Advisors, Inc. **Fourth Quarter 2007**

2007 was a turbulent year that saw the housing market take a dive and the credit markets seize up. Many financial stocks were hit hard, but overall returns on the year were modestly positive.

The housing contraction has a direct impact on employment and spending, but the related credit crunch could cause the most damage.

Presently most asset classes do not appear to be bargain priced despite all the worries. But they are not expensive and some sectors look to be very cheap from a long-term standpoint.

With a higher risk of recession, we are assessing whether we should increase our defensiveness. Because our scenario analysis suggests that our portfolios can withstand a normal recession without violating 12-month risk thresholds, any moves we make are unlikely to be dramatic.

Quarterly Investment Commentary

For the most part, fourth-quarter returns were consistent with the rest of the year. Commodity prices moved sharply higher, as they did over the full year. Emerging-markets continued their advance (there is an embedded commodity play in some of these markets). Developed country foreign equities declined, a reverse after a strong advance earlier in the year—but they still out-returned the U.S. equity market, which was down across all styles in the fourth quarter. Value continued to underperform growth in the fourth quarter, this time on the downside—and was in the red on the year. Growth stocks delivered decent positive returns for the full year. Small-caps continued to lag large-caps and were also in the red for the year. REITs' collapse intensified, as they dropped almost 13% in the fourth quarter alone. As recession fears increased, bonds performed well in the quarter and ended up with a solid 7% return for the year—ahead of the broad stock market.

2007 Retrospective

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in home-building or lending were crushed, and resulting economic worries triggered stock declines for many consumer goods companies. While all this was going on, U.S. exports were booming and reached an all-time high of 12.1% of GDP (as of 9/30/07). Not surprisingly, companies with significant foreign-based earnings did well. Overseas stocks also delivered great returns. Related to the overseas story was the continuation of demand for energy and raw materials commodities from China and other high-growth developing countries—a trend reflected in the strong performance of the energy and materials-related sectors.

There was action in the bond market as well. Investors first worried about inflation and then recession. At times they worried about both. The 10-year Treasury yield ranged from a high of 5.25% in June to a low of 3.85% in November. The best action was overseas as the dollar's drop gave U.S. investors currency gains that enhanced their returns. But outside of the government bond market, perceived credit risk rose, leading to underperformance.

For us, it was a year when each of our tactical asset allocation moves added value versus our benchmarks. Our three asset class plays continue to be: 1) an overweighting to large- and mega-caps that is funded from a reduction in small-caps; 2) a position in emerging-markets local currency short-term bonds that is funded from a reduction in U.S. investment-grade bonds; and, 3) commodity futures, also funded from investment-grade bonds.

During the year, our fixed-income managers added considerable value versus their benchmarks. Portfolios using municipal bond funds in place of PIMCO Total Return did not fare as well, as the taxable PIMCO fund out-returned Vanguard's intermediate-term muni fund even on an after-tax basis (though the Vanguard fund did well versus its benchmark). We wouldn't be surprised to see high-quality tax-exempt bonds make up some of that performance differential over the coming year, however.

Our international equity managers also outperformed overall. However, our domestic equity managers' performance was mixed, and in aggregate underperformed the S&P 500. Generally our growth managers did well but our value and blend managers generally lagged their benchmarks, with a couple suffering through very poor years (Bill Nygren of Oakmark had an especially poor year).

Remaining Focused Amidst Information Overload

"Everybody gets so much information all day long that they lose their common sense."— Gertrude Stein

In the trenches of the money management business it is a constant struggle to avoid information overload while staying on top of the right information. The amount of analysis and data and the breadth of information available amounts to a tsunami compared to what was available 16 years ago. We had rather have more information than not enough but, it takes discipline to stay focused on the right information and not get distracted by the (sometimes interesting) less relevant information. Sometimes it takes creativity and persistence to find the data or research that we need to get to the right conclusions. Even with the challenges that we face with an information explosion, one thing hasn't changed, and that is the critical importance of a common sense overlay that brings us back to what really matters and helps us resist the temptation to either overanalyze or make decisions based on knee-jerk reactions. We think this common sense is one of our strengths.

So what matters most right now? Two things:

- The underlying economic and investment fundamentals
- Understanding what is reflected in current security prices

There are other things that matter when it comes to portfolio construction, such as scenario analysis, but with respect to assessing competing investment opportunities—which is what investing is all about—these two areas are where we focus our attention. In each of these the challenge is the same: to sift through a seemingly limitless supply of information and determine what is most important. An additional challenge is to stay intellectually honest about what we can confidently know or assess and what we can't. (A variable may be very important but unpredictable or unknowable, like, say, next month's inflation rate.) One of the common failings of amateur and professional investors alike is thinking that they are smarter than they really are, i.e., overconfidence. All it takes is a few right calls to start believing you're Nostradamus.

Another challenge is finding the right balance in communicating our thoughts to you. We like to give you enough detail so that you can understand the basis for our investment decisions and know we do our homework, but don't want to overwhelm you (of course, you can always cut straight to

the conclusion if you find the detail to be too much). With that, we'll offer our take on where we think we stand after a very eventful year.

2008: Big Worries … Any Opportunities?

Our investment decisions are always made based on a multi-year outlook. This allows us to focus on underlying fundamentals and valuations—the factors that ultimately drive returns—and distance ourselves emotionally from the day-to-day "noise" of the markets and the financial media. Over shorter time periods these relationships—between fundamentals, valuations, and returns—don't always hold. This is the point made in the legendary Benjamin Graham saying "In the short-term the market is a voting machine but in the long-term it is a weighing machine."

The question most investors are asking at this point is: will the troubled housing and mortgage industries take down the economy? The underlying key is consumer spending, which makes up 70% of the economy. The contraction in the housing-related industries has a direct impact on employment and spending, but it is the related credit crunch and its impact on spending that could cause the most damage. The impact of hundreds of billions of dollars in loan losses to banks, hedge funds, and other investors means less capital available to lend, and less willingness to lend because of uncertainty about the borrowers (and because of the need to keep cash on their balance sheets to cover their own potential losses). Moreover, capital has increasingly come from outside the banking system (structured notes are an example), making it tougher for the Fed to restore confidence and liquidity.

The problem is that it is difficult to quantify the losses and impossible to confidently forecast how restrictive credit will be and for how long. There is also fear that credit problems will spread to other areas, with credit cards being one area of concern because of permissive underwriting standards. At this point it seems pretty clear that banks will have more write-offs over the next few months or quarters and that structured investments (pools of debt that have been turned into securities), which are often highly leveraged, will suffer through more ratings downgrades as collateral values decline further. Certain types of hedge funds, which have exposure to these vehicles, are likely to suffer sizable losses in coming months. Moreover, it is very likely that lending practices will be generally more conservative, suggesting slower growth in credit for a sustained time period. A predisposition to conservative lending will make the Fed's job harder. This suggests that the current trend of less credit and higher costs probably has a way to go. This is true not just in the mortgage market (subprime and prime) but in the consumer and small-business loan market as well.

It is easy to dwell on the negatives and this is a common investment mistake that we've seen (and sometimes made) over many years. It is not a foregone conclusion that the negatives will drag the economy into recession—though some slowdown seems quite likely. Although the employment market is showing some signs of slowing (unemployment claims are starting to rise), it remains healthy. Corporate earnings outside of the financial sector are still growing. Emerging markets continue to thrive and are a positive for the global economy. A weaker dollar has helped support a boom in U.S. exports. The Fed and other central banks are aware of the economic risks and are using interest-rate policy and other measures to improve liquidity. They will not stop until they have an impact, though how quickly this will happen and how successful they will be is not yet clear. Overall, global liquidity remains strong with large foreign exchange reserves and huge growth in sovereign wealth funds (government controlled investment funds created to invest foreign exchange reserves), two indicators of liquidity. There are already some tangible examples of available liquidity, including recent investments in major but troubled financial institutions by Chinese, Singaporean, and Middle Eastern investors. As we weigh the information we have, we know we can't confidently predict how the macro picture will play out. However, we believe the odds of a mean-

ingful slowdown or even recession have moved sharply higher from a few months ago, though a recession is still far from certain.

That there is big-picture uncertainty is nothing new—it's always a given. And as always it begs the question: what is priced into the markets? This is important because at times the relationship between the macro climate and security prices disconnects. When fear is high, investors avoid risk, driving up the prices of safe assets and driving down the prices of riskier assets—often to excess. The result is that riskier assets usually are bargain priced when fear is high, and vice versa. Presently most "risky" assets (anything other than cash and investment-grade bonds) do not appear to be bargain priced despite all the worries. But mostly they are not expensive and some sectors look to be very cheap from a long-term standpoint. One quick valuation reality check is to look at trailing returns for riskier asset classes. When trailing returns are very high, especially over a lengthy period, chances are that the asset class is richly priced. But when returns have been low or average for a long period, chances are the asset class is undervalued or fairly priced. Currently, trailing longer-term returns are not so high as to suggest inflated asset class valuation levels.

Conclusion

Looking ahead, the impact of the housing slump and lack of liquidity in the credit markets has increased the level of economic risk, and recession is a clear possibility, though not necessarily a high probability. However, clients should understand that the possibility of a rough year lies ahead. They should also understand that this is not an outcome that can be predicted with high confidence. We've been surprised by positive market returns many times over the years. So we focus on doing our best to maintain adequate risk protection over a one-year time horizon based on the risk tolerance of each investor, while keeping our eye on the more important goal of long-term returns. This common sense approach has served our clients well over the past 16 years.

If the current turmoil in the credit markets and/or an economic downturn triggers a severe sell-off, we are likely to see tactical opportunities created in several asset classes or at a stock-picking level. In fact, at a stock-picking level we may already be at this point, with some large financial firms selling far below what their fair value would be if (after the credit crisis abates) their earnings return to normalized levels. However, given the fear and uncertainty, it is likely to be a while before their stocks reflect their longer-term potential. At an asset-class level we are not there yet—and we may not get there soon—but for long-term investors, market turmoil can create great opportunities. We will continue to evaluate the opportunities the markets present, and will seek to take advantage of them when we believe it is prudent.

We appreciate your confidence and trust.

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