Altamont Capital Management

Third Quarter 2007 Performance

"Things may come to those who wait, but only the things left by those who hustle."
Abraham Lincoln

The Third Quarter was another roller coaster ride that almost defied gravity on the downside and upside. The average general domestic stock fund was up 1.2 percent, according to Morningstar. The S&P 500 (a proxy for large stock performance in the U.S.) was up a respectable 2.1% (the ETF proxy used in the adjacent chart outperformed the index, generating a 3.1% return). The small and mid cap sectors of the U.S. markets did not fare as well.

International stocks in developed countries persevered and performed well. Interestingly, many specific country markets were down for the quarter which validates keeping your international portfolio diversified across countries and regions. A substantially weaker dollar bolstered returns from international investments this quarter so their returns were as good as or better than that of the S&P. The average foreign stock mutual fund gained 5 percent for the quarter.

International emerging-market funds continued on a tear, up 17%. Emerging markets refers to countries that are under developed and rural in nature. China and India are countries commonly referred to as having emerging economies. Growth in these regions has been astronomic (up 35% year-to-date).

Third Quarter 2007 Benchmark Index Returns

	Third Quarter	Year To Date
Large-Cap Benchmarks		
S&P 500 iShares	3.1%	9.9%
S&P 500 Growth iShares	5.0%	11.7%
S&P 500 Value iShares	1.7%	9.2%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	-1.0%	10.8%
S&P 400 Midcap Growth iShares	0.7%	14.2%
S&P 400 Midcap Value iShares	-2.6%	7.4%
Small-Cap Benchmarks		
S&P 600 iShares	-1.9%	6.4%
S&P 600 Growth iShares	1.3%	12.1%
S&P 600 Value iShares	-4.8%	1.3%
Other Benchmarks		
MSCI EAFE Int'l iShares	3.6%	14.2%
MSCI EM Int'l iShares	17.1%	34.8%
Vanguard Total Bond Mkt Index	3.0%	3.9%
DJ-AIGC Commodities Index	5.9%	9.8%

Size mattered this quarter. The more super-sized your portfolio was (weighted toward the biggest large cap equities), the more bang you got for your investments. The strongest growth has occurred abroad this year and the US mega caps that have the largest international component to their earnings. The S&P500 ishares generated 3.1% third quarter while the S&P400 MidCaps and the S&P600 SmallCap ishares fell. International large caps also outperformed international small caps this quarter for the first time in years.

Growth also stole the spotlight, outperforming value despite capitalization (cap size) and country. S&P500 Growth ishares were up 5% for the quarter while the S&P500 Value ishares gained only 1.7%. This pattern was true for the smaller cap indices such as the S&P400 and S&P600 ishares, with the value shares falling and growth shares holding their value.

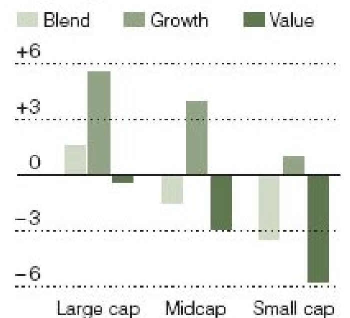
Q3 2007

	Value	Blend	Growth
Large	-0.2	2.0	4.2
Mid	-3.5	-0.4	2.1
Small	-6.3	-3.1	0.0

Year-to-Date

	Value	Blend	Growth
Large	6.0	9.1	12.7
Mid	4.8	9.5	13.3
Small	-2.7	3.2	9.3

The reintroduction of risk was very apparent in the bond market, with high quality bonds rising in value and low quality falling. Scared by the upheaval in the credit markets, investors began piling into high-quality bonds, drove the Lehman Brothers Aggregate Bond Index up 2.8%, and caused yields to fall. For example, the yield on the U.S. 10-year Treasury note settled at around 4.5%, down from about 5.2% in mid-June. (Because bonds offer a fixed coupon, their yield--the coupon rate as a percentage of the price of the bond--shrinks as bond prices rise.) The popularity of Treasuries (flight to quality) also caused the Merrill Lynch U.S. High Yield Master Index, an index of low-rated (junk) corporate bonds, to post a modest 0.12% loss for the quarter.



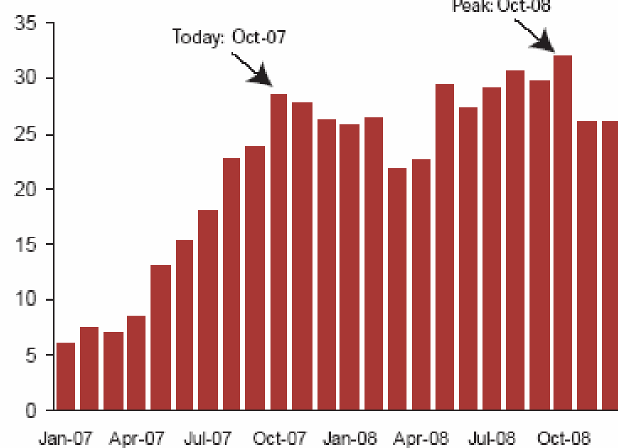
Other parts of the fixed income markets have not fared as well. The subprime mortgage-backed market is nonexistent, making it impossible to gauge the value of many existing securities. Many banks are writing them off as worthless. Despite this nuclear melt down, the Eaton Vance Institutional Floating Rate has performed well: although it fell 1.8% for the quarter, it is still up 2% for the year.

Commodity futures performed well this quarter due to the surge in oil prices, which breached the $80 a barrel level. The PIMCO Commodity Real Return Institutional Fund rose 10% in the third quarter generating a year-to-date return of 13%. The iPath Dow Jones-AIG Commodity Index rose a more modest 6% during the quarter and 10% for the year.

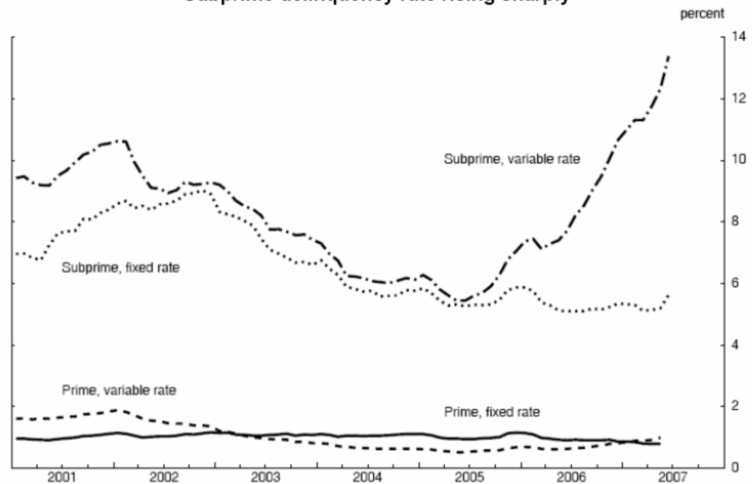
Emerging-market short-term bonds (PIMCO Developing Local Markets) continue to perform well despite volatility in the fixed income arena. Year-to-date the fund is up 4.5% primarily due to declining value of the dollar against other currencies.

So What Happened This Quarter and What's Next?

The pizza guy delivers a pizza to your door. He wants to be paid in cash right now. He doesn't care how much equity you have built up in your house. You look in your wallet and it is empty. This scene is playing out for many home owners. They can't make their mortgage payments and the bank is knocking on their door demanding payment. These resetting mortgages payments have ballooned to a level that borrowers aren't able to pay. Why did the banks and secondary lending institutions make these loans to people they knew would never be able to repay? Greed! Wall Street was clamoring for these riskier mortgages because they were looking for bonds that generated a higher yield (higher interest rates) and to heck with the risk. In particular, hedge funds had an insatiable appetite for these riskier asset-backed consumer loans. Here is the bad news: the worst is yet to come. The most egregious of these risky loans (with high escalating payments at reset) were 2 year Adjustable Rate Mortgages made in 2006 and early 2007. As the above graph shows there is **a massive wave of these loans that will reset in 2008**. The default rate will be significant. This is like watching a train wreck in slow motion.



Unfortunately, when excesses end, things don't just return to normal. The pendulum frequently swings far in the other direction. This quick swing sparked a **liquidity crisis on Wall Street**. The mortgage defaults triggered an extreme lack of interest in holding consumer-backed debt, and an inclination on the part of most institutions not to lend to each other. This cascaded into broader risk a-voidance on the part of investors, hedge funds, and other financial market players who have played an important role in ex-panding the amount of available credit. This was greatly exacerbated by large a-mounts of leverage (debt) held by many of the non-bank credit providers (e.g., hedge funds). The result was that credit, which as noted is crucial to the economy, was sharply re-stricted for a few weeks during the quarter.



Source. First American LoanPerformance

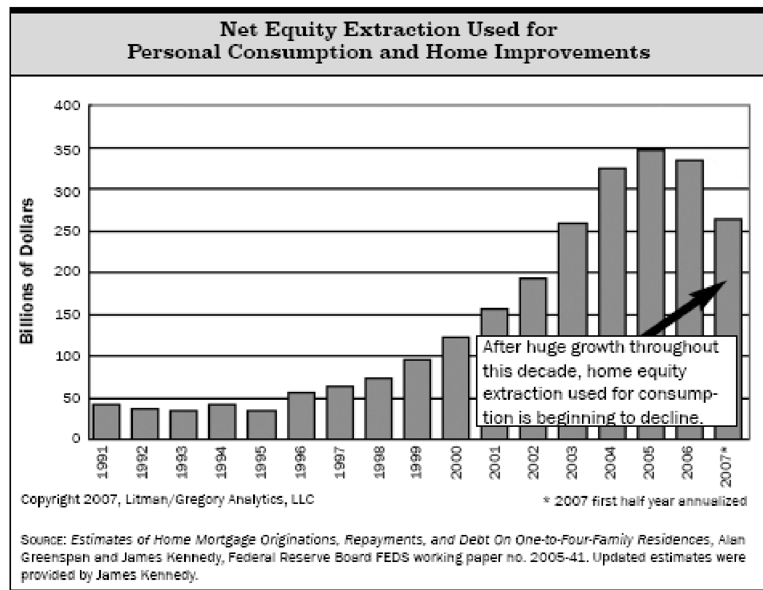
With the **Fed's decisive action in September** to cut the federal funds rate by 50 basis points, things have settled down, but they have not returned to normal. Capital will no longer be available to certain groups of borrowers and it will be costlier to other groups. This is somewhat good because excess liquidity was leading many investors to make imprudent investment decisions. On the flip side, the seizing up of the credit markets in a credit-dependent economy has a ripple effect which will hurt consumer spending.

Investment Returns	👍 👎	Despite higher volatility, equity markets managed to push higher during the quarter. The S&P 500 Index is up 9% year-to-date.
Overall Economy	👍 👎	Despite housing and credit woes, the economy has remained resilient. Q2 GDP growth was revised to 3.8%, but is likely to slow in the second half of the year.
Employment	👍 👎	Unemployment remains low at 4.6%. However, the economy suffered its first month of negative job creation in four years.
Earnings	👍 👎	Despite slower profit growth, companies continue to surprise on the up-side. Profit *levels* remain at record highs.
Interest Rates	👍	The Fed lowered its key target rate 50bps to 4.75%, an action targeted at alleviating the potential economic strains of tight liquidity markets. The yield curve is "normally" shaped.
Inflation	👍	The Fed stated that, "Readings on core inflation have improved modestly this year", but added, "some inflation risks remain".
Key News Items	👎	President Bush gave his eighth national wartime address. Housing-related headlines continued to dominate the financial press.
Fund Flows	👍 👎	Flows into International equities continued to outpace U.S. flows. Fixed Income flows accelerated. Pervasive flight to quality across all asset classes.

Source: Standard & Poor's, FRB, BLS, BEA, JPMorgan Asset Management

With consumers unable to use their homes as an ATM machine (consumers extracting capital from their homes largely shut down) and home sales severely slumping, the economy is faced with the possibility of a material cutback in **consumer spending**. The primary driver of economic growth is consumer spending, which accounts for approximately two thirds of the US economy. Some industries are already slumping since consumers have less cash available to spend on their homes and lifestyle. For instance, the furniture, home improvement and auto industries are already feeling the pain. The homebuilders and

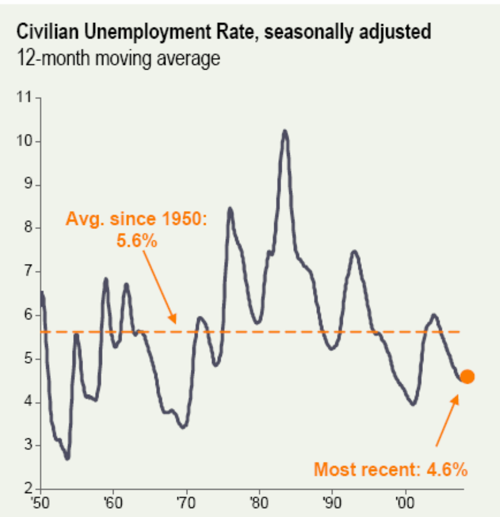
mortgage lending industries have also begun to retrench. All this has a negative multiplier effect on the economy. It seems highly probable that the economy will, at the very least, experience slower growth.



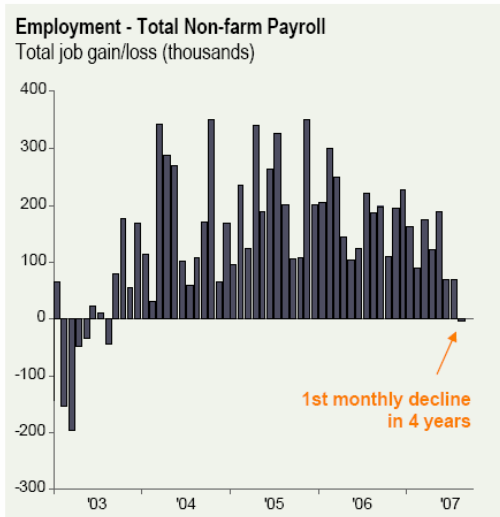
A key to assessing the future impact of declining consumer spending will be the **labor market**, which until recently had been pretty healthy. It had begun to exhibit a few signs of weakness over the past few months, even before the summer meltdown.

Although the labor market continues to soften, the Manpower Inc. labor survey held steady for the third consecutive quarter. Initial jobless claims have seemed to stabilize recently and remain quite low by historical standards.

Since the end of the quarter, initial jobless claims fell to 308,000 for the week ended Oct. 6, to a remarkably lean level, which is about the same level it was a year ago. It appears that for now the U.S. labor market is actually tightening. Based on the most recent data the labor market does not appear to be weakening.



Source: BLS, JPMorgan Asset Management
Data reflects most recent as of 9/30/07.



Source: BLS, JPMorgan Asset Management
Data reflects most recent as of 9/30/07.

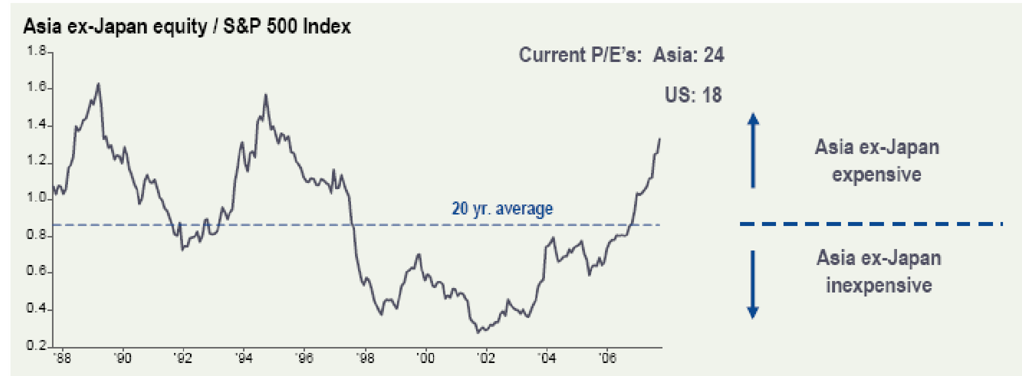
The **weakness in the dollar,** as long as it doesn't turn into a rout, is like an interest rate cut. It will help U.S. export growth, which has already been very healthy, and contribute to the bottom line of U.S. firms that do business globally. Meanwhile, a dollar collapse is unlikely because this outcome would be very harmful to the global economy. For this reason central banks around the world would take extreme measures to avoid it.

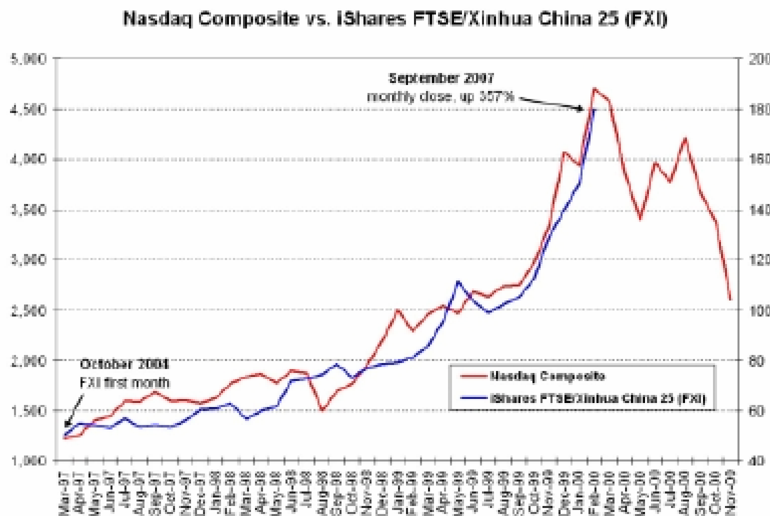
There are some cracks appearing in the international markets. The credit crunch is being felt around the world, not just in the U.S. In particular, Europe is having a similar experience in the housing market. The Bank of England (BoE) Governor Mervyn King characterized the situation as a "major problem" that is dimming the economic outlook in the United Kingdom, where house prices in August 2007 fell for the first time since 2005.

Recognizing the severity of the dysfunction in the financial markets, the European Central Bank (ECB) continued to add enormous amounts of liquidity to its banking system. The BoE and the ECB insist that the repricing of risk (a.k.a. liquidity crisis) is manageable, and they continue to believe that the banking

system remains fundamentally sound. Given the degree of calm that has returned to the credit markets (at least for the time being), the banks appear to be on course.

On the other hand, emerging markets appear to be vulnerable. China is facing an inflation spike (+6.5%). Inflation is rising at the fastest pace in more than 10 years. The culprit is almost entirely food costs, caused by supply constraints. The Chinese government is trying to contain the inflation with price controls. The core rate of inflation (which excludes food and energy) has remained very low near 1% since 2004, but this could be partially due to government interference (controls). Concerned about inflation, the People's Bank of China has increased interest rates again and is likely to keep tightening. Consumer spending (retail sales +17.1% year over year) remains too hot and is not sustainable. Unless China can begin to rein in its growth and control inflation we could be looking at a major correction. Investing in only one country or region is risky. The investment inflows into Asian and Chinese oriented investment vehicles have been of tsunami proportions.



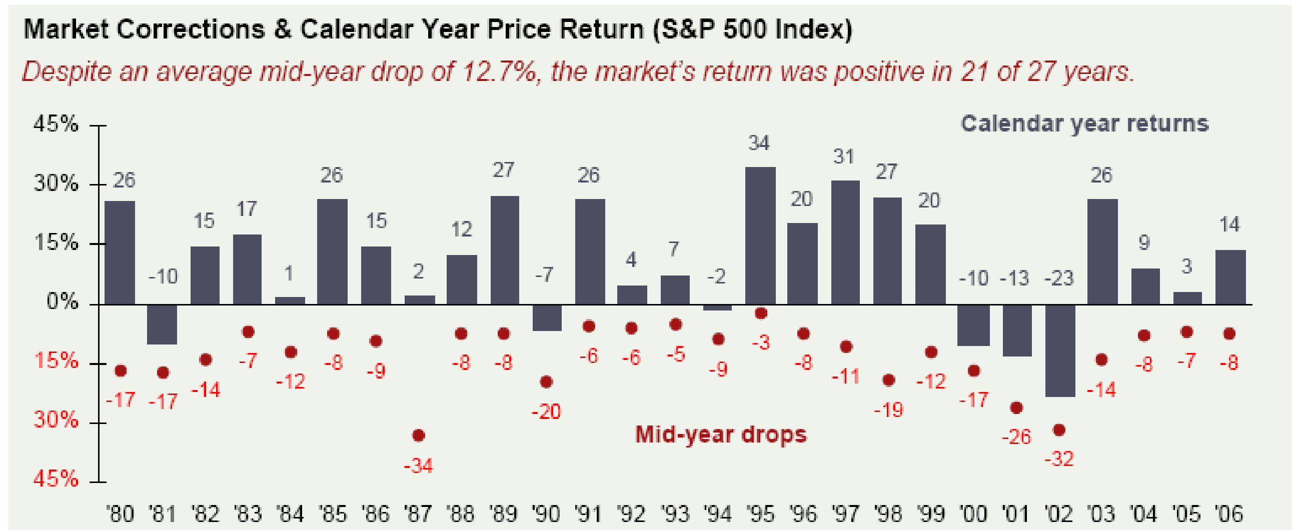


Is the Chinese market ready for a correction? See tha adjacent graph comparing the NASDAQ Composite monthly closing prices for the 3 years leading up to the spring 2000 downturn versus the monthly data for the last 3 years of the iShares FTSE/Xinhua China 25 Index (FXI). The resulting linear comparison of the two indices is rather striking and the ascent of the FXI share price is on a nearly identical trajectory to the NASDAQ composite of early 2000. I am sure this took some manipulation of the graph's scales, but the result is alarming. Will the Chinese stock market suffer the same fate as the NASDAQ anytime soon? That is unclear, but a pullback sooner or later is inevitable.

I have not invested in emerging markets funds because most international funds have a 5% plus allocation to emerging markets. I feel strongly that this is a large enough allocation to this sector given its inherent risk. I am firmly committed to increasing the allocation of international stocks and bonds in each client's portfolio. My goal is to structure each portfolio so that the overall equity allocation is equally-weighted between U.S. and international stocks. As we become a global economy this equally-weighted allocation just makes intuitive sense, but in the investment world this is a radical strategy. Most investment strategy is fashioned by looking at history (backwards) and frequently misses

indicators that signal major shifts in the economic paradigm. The world is no longer U.S.-centric and this shift in growth is recognized in your portfolio allocation.

If you listened to the news media this summer you might have thought the sky was falling. The sky is fine and the markets are sound, what happened this quarter was the return of normal volatility. Yes, the markets went up then down and up again but this is normal. I love the chart below because it illustrates how volatile the markets usually are in any one year. For instance, in 1998 the S&P500 index (ex-dividends) generated a 27% return but at one point during the year the index was down 19%. The index has generated on average an annual 10% to 11% return despite suffering an average mid-year drop of 12.7%. The moral, stay focused on the long term (at least a three year if not 10 year time horizon) and ignore the day-to-day gyrations of the market.



Source: JPMorgan Asset Management, Standard & Poor's. Market returns represented by S&P 500 Index return and do not include dividends. Mid-year drops refer to the largest market drops over periods of 6 months or less. Calendar year refers to the price return for the S&P 500 Index for each calendar year.

Please remember to review your quarterly rebalancing sheets and return them as soon as possible. My recommendations are timely and returning the rebalancing a month after its receipt negatively impact your portfolio's performance.

I took a summer vacation from blogging but I have started again. I am posting brief updates more often. Also the Contra Costa/Valley Times new business editor has, in his infinite wisdom, discontinued the investment panel's column. If you miss reading my column please give Drew Voros, the business editor, a call at (925) 943-8099 or drop him an email at dvoros@cctimes.com and tell him you want me back as a columnist.

Thank you for your confidence and trust.

Libby Mihalka