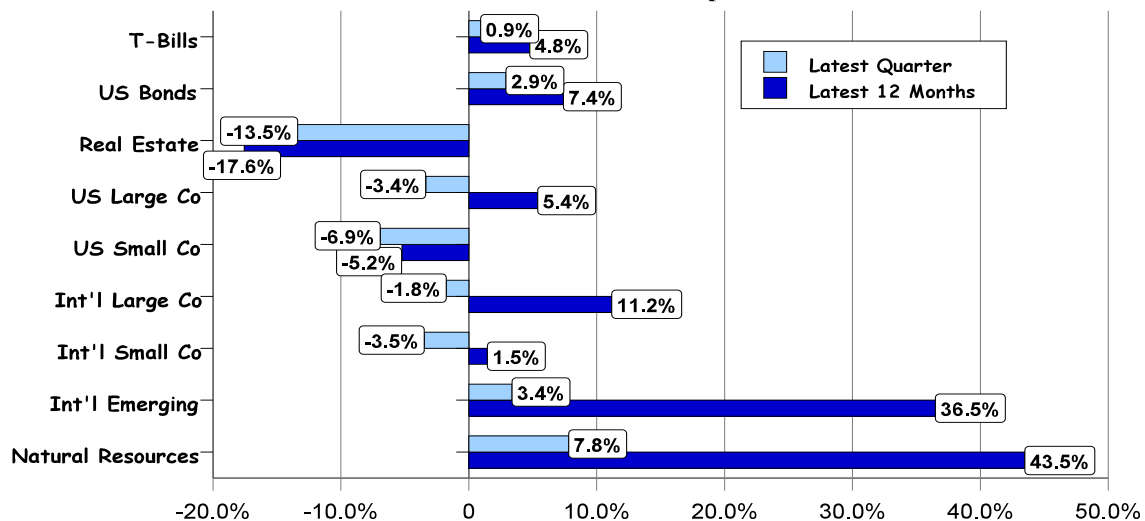


**Are We There Yet?**

Dear Client:

Do you recall in our youth while riding in the back seat of our parents' car when we'd keep asking, "are we there yet?" While the official announcement of a recession is probably months away, assuming it comes at all, it sure feels like we're almost there. Just three months ago, retired Fed Chief Alan Greenspan assigned the odds of a recession at less than 50%; today, the financial press is littered with pronouncements of the recession's arrival and how investors should adjust their portfolios. It seems like we're at the "tipping point" when the question has become not "if," but rather "when" the Recession of 2008 will become fact. And in kind of a perverse self-fulfilling way, all the negativity and talk of a recession may help to assure its arrival. In my last quarterly letter, I mentioned that recessions are probably as inevitable as death and taxes and that they occur as a normal part of the economic cycle about once in every eight to ten years. Some investment strategists suggest that recessions are good for us as they "purge" the excesses out of the economy and lay the groundwork for a subsequent recovery and future growth. Later in this letter, I will review the history of recent recessions to determine whether or not any lessons might be applicable as we look toward the future. First, however, let's take a look at the results of 2007 which ended up mostly positive despite all of the bad news and turmoil.

**Asset Class Performance Comparison**



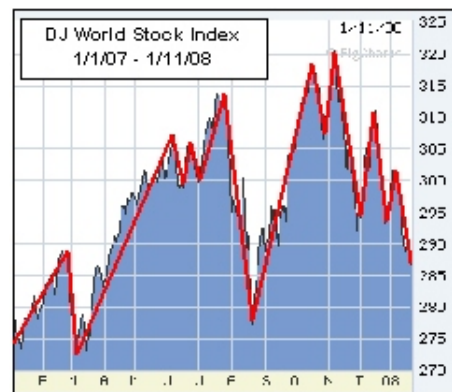
**Asset Class Performance Observations**

The returns for the quarter ending December 31st were negative for the majority of asset classes as the sub-prime tidal wave continued wreaking havoc in the financial markets. This was also the first quarter when real signs of an economic slowdown became evident. On the negative front, Real Estate securities (-13.5%) took the brunt of the blow as credit continued to tighten and financing costs rose. US Small Company stocks posted their second consecutive losing quarter with a loss of 6.9%. And for the first time in a while, both International Small and International Large Cap stocks registered losses of 3.5% and 1.8% respectively. US Large Company stocks were not immune from the latest turmoil, either, with a loss of 3.4%. The safe havens for the fourth quarter, ironically, were at opposite ends of the risk spectrum. At one end, T-Bills (+0.9%) and US Bonds (+2.9%),

traditional refuges from the volatility of the stock market, performed well as some investors continued their "flight to safety" given the perceived perils of lower quality fixed income investments. At the other end of the risk spectrum, Emerging Markets stocks, by far one of the riskiest of asset classes, provided a gain of 3.4% as investors seemed to slough off our own economic woes in favor of a belief that emerging economies continue to offer solid long-term growth prospects. Finally, with oil reaching \$100 per barrel and higher expected inflation, it's probably unsurprising that Natural Resource stocks (+7.8%) posted the best gain for the quarter.

For the full twelve months of 2007, all but two asset classes posted positive returns; and despite a real roller coaster of a year (refer to the graph at right), a globally diversified portfolio performed surprisingly well. The big winners were, once again, Natural Resources (+43.5%) and Emerging Markets (+36.5%). Returns like these are rare in the annals of investment history and they may not be seen again for a while if the global economy follows the US into a slowdown or recession. Natural Resources and Emerging Markets, due to their big run-ups, have been the primary "victims" of our portfolio rebalancing sales over the past year (i.e., subtracting excess gains from outperforming asset classes and adding the excess to lagging asset classes).

Next on the performance review were International Large Companies with an 11.2% gain attributable largely to the falling US dollar which has benefitted most non-hedged foreign investments. Measured in local currencies, the return on International Large stocks only amounted to 1.2% which means that a full 10% of the total return was due to the falling dollar! The next best performing asset class was US Bonds which gained 7.4% for the year surpassing its historic average return of 5.5%; the flight to quality and falling interest rates helped propel bonds for 2007. Coming in neck and neck in the performance derby were US Large Company stocks (+5.4%) and US T-Bills (+4.8%). Despite the prognostications favoring Large Cap stocks, the 5.4% annual return was well below its historic average of 10.3%. The final positive return came from International Small Companies which came in at a meager +1.5% which, in local currencies, would have been a negative 8.5%. In the losing camp were US Small Cap stocks (-5.2%) which posted their first calendar year loss since 2002. Lastly, US Real Estate came in with a loss of 17.6% for the year, a plummet of more than 25% from its high in early 2007.

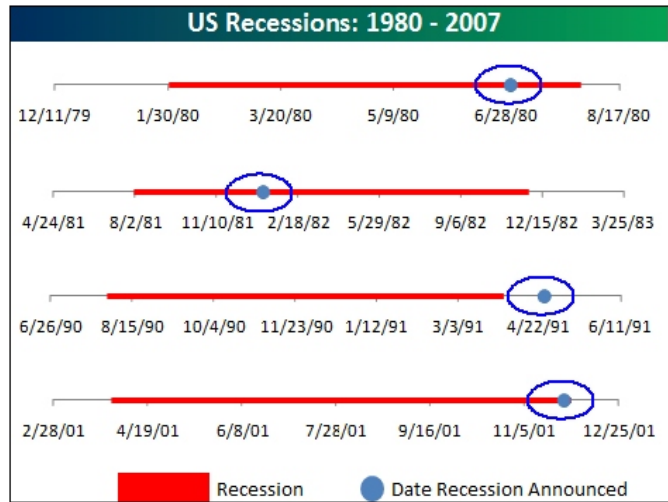


the 5.4% annual return was well below its historic average of 10.3%. The final positive return came from International Small Companies which came in at a meager +1.5% which, in local currencies, would have been a negative 8.5%. In the losing camp were US Small Cap stocks (-5.2%) which posted their first calendar year loss since 2002. Lastly, US Real Estate came in with a loss of 17.6% for the year, a plummet of more than 25% from its high in early 2007.

**Are We There Yet (continued)**

Some look at the stock market as a predictor of future economic health, the logic being that investors will weigh expectations for future corporate earnings growth when determining the prices they are willing to pay for stocks. If investors feel the economy may be slowing down, they might conclude that current stock prices are too expensive; and if they believe the economy will be expanding, they may be willing to pay more for stocks. With the latest stock market turmoil, especially in early 2008, some pundits are saying that the stock market is clearly anticipating a recession; hence the reason for the 5% to 10% plunge in stock prices through the first two weeks of January. Unfortunately, the stock market has not been particularly accurate in predicting recessions, a fact which didn't elude the late economist Paul Samuelson who quipped that "the stock market has accurately predicted nine of the last five recessions." Certainly the stock market is telling us something these days and whether or not we are in a recession is probably only a technical point. Let's take a look at the recent history of recessions to see if there are any lessons for us. Recessions are technically defined as two consecutive quarters with negative economic growth as measured by the Gross Domestic Product (GDP). While we have not had a negative quarter in the GDP yet, many economists predict that we will experience a mild recession in 2008 with a duration of six to nine months (the definition of a shallow and short recession). On the other hand, some investment strategists are predicting a more severe recession which may run deeper and last longer, perhaps rivaling the recession of the early 1980's, or even the early 1970's under a worse case scenario. Those in the mild

recession camp suggest that several factors may limit the depth of the next recession including: (1) proactive measures by the Fed to further lower interest rates and thus kick-start future economic growth, (2) fiscal stimulus provided by temporary tax cuts (the throng of political candidates are jumping all over this one) and (3) continued growth in our export economy which is the main beneficiary of a weaker US dollar. Those in the more severe camp feel that most of the stimulus by the Fed and from tax cuts will be too little and too late; that rising inflation, primarily due to high energy costs, and a slowing economy may create a period of "stagflation," akin to the early 1970's recession during the OPEC oil embargo. There is also the possibility that we may not see an actual decline in the GDP for two consecutive quarters (the definition of a recession) due to an economic dichotomy where certain sectors of the economy, such as those deriving greater benefit from exports, may be booming while other sectors, such as housing and finance, may experience a severe contraction. In this scenario, the benefits of a weak US dollar may strengthen the export component of the GDP sufficiently to compensate for the contraction in the declining sectors. While this occurrence might technically avoid a recession, the pain felt by many would nonetheless be severe.



As mentioned previously, recessions have occurred once in every eight to ten years with an average length of ten months. One of the problems in determining the impact of recessions is that they typically begin long before they are officially announced. In the chart above, note that in three of the last four recessions, the official announcement occurred toward the end of the recession period. In one instance, the 1990 recession, the announcement didn't occur until after the recovery had begun! (One may wonder about the usefulness of the National Bureau of Economic Research which is responsible for the official announcements.)

Just how a recession might affect investment portfolios is obviously the point of this discussion. In the table below, I've indicated how a globally diversified 100% stock portfolio fared during the last five recessions (adding bonds to the mix would have reduced volatility). I found it interesting that during three of the past five recessions, stocks actually posted gains and in only one recession (1973-75) did stocks suffer significantly. Most importantly, following four of the five recessions, stocks had positive results; and following the longest and deepest recessions (73-75 and 81-82), the gains were extraordinary (+29.3% and +31.3% respectively). Perhaps one of the first lessons about recessions is that market timing may be ill-advised given the fact that stocks have often posted robust gains in the recovery period. On the other hand, are there any lessons to be learned during the period leading up to a recession (perhaps that's where we are today, if the recession proponents are correct)? Here's where it gets tricky; remember the National Bureau of Economic Research? Well, if one doesn't know for certain when a recession actually begins until it's practically over, then trying to determine what sort of action one might take beforehand is particularly problematic (a crystal ball anyone?). Let's assume, however, that we

Stock Market Performance Before, During & Following Recent Recessions				
Recession	Duration (Months)	Performance of a Global Portfolio*		
		12 Months Preceding	During	12 Months Following
11/73 - 3/75	16	-2.4%	-14.5%	+29.3%
1/80 - 7/80	6	+21.6%	+14.9%	+17.5%
7/81 - 11/82	16	+27.8%	+5.5%	+31.3%
7/90 - 3/91	8	+5.2%	+1.1%	+10.6%
7/01 - 11/01	8	-11.4%	-5.6%	-9.8%

\* Global Portfolio invested 33% each in US Small, US Large and Foreign Stocks.

could foretell the advent of a recession and that our clairvoyance was particularly skillful so that we could take action twelve months in advance. Even under these circumstances, the historic evidence is mixed as to whether taking any action at all would have been warranted. In only two of the five past recessions were stock returns negative during the preceding twelve months; and even during the big daddy recession of them all (73-75), the negative return was minimal (-2.4%). Further, even during the 73-75 recession, the cumulative return on stocks for the twelve months preceding and sixteen months during the recession (-16.9%) was less than the subsequent twelve-month return during the recovery (+29.3%). Only in the 2001 recession were stock returns negative in all three periods. What made the 2001 recession so atypical (and painful) for investors was that stock valuations prior to that recession reached a record high (i.e., a P/E ratio valuation on the S&P 500 of more than double the historic norm). Stock prices had already begun to correct in early 2000 and the recession merely helped bring them down to earth more quickly. The extreme overvaluation of stocks in 2000 led to the infamous Tech Wreck Bubble which took a full three years to deflate; stock returns since then have more than made up for any lost ground. (An important observation to add about a possible recession in 2008 is that stock prices today are not wildly overvalued as they were in the year 2000; in fact, by most measures, stock prices seem to be in line with their historic average valuation levels.)

Based upon the evidence over the past thirty years, the major lesson appears to be that investors are probably best served by not making any significant adjustments to their portfolios *assuming they have established a prudent global asset allocation strategy to begin with*. Given the view by most economists that future global growth will be strong, although perhaps at a slower pace in the short-run, a globally balanced portfolio offers the benefit of diversifying across many economies where the effects of an economic slowdown in one country or region might be partially offset by stronger growth in another country or region. On the other hand, should the next recession cascade into a global recession where all regional stock markets would suffer, then the balanced portfolio's allocation to bonds would help to minimize any short-term losses. Patience, as well, would likely be rewarded during the recovery.

### **Predictions for 2008 from the Pundits**

Normally at this time of year, I offer a review of the various prognostications from a range of investment strategists, including those who see positive results for the stock market in the coming twelve months to those pessimists who predict negative returns. This year, I found general consensus that the first half of 2008 will continue to be very volatile, with some using the adjectives "scary", "terrible" and "awful" to describe the market's path. Most strategists predict a decline in stock prices of between 10% and 15% for the first half of 2008, although this may be understated given that segments of the market are already down by between 5% and 10% in just the first two weeks of January alone. As for the second half of the year, the consensus view was that much of the bad news about the economy will be shaken out and the stock market will recover to end the year with either a small loss of around 5% or a modest gain of between 5% and 10%. A few strategists predicted a deep recession, but most thought that the US would either avoid a recession or experience a mild version. There was general agreement that the US economy stood to suffer the most as a result of the deflation of our housing and credit bubble, but that the global economic expansion would continue fueled by growth in the emerging economies, albeit at a slower rate. Finally, there was consensus that the economy needed to wring out the excesses in housing prices and the credit markets before a recovery could begin (i.e., we needed to experience some pain before we would see the gain). It seems clear that the path for the stock market during this wringing out period will likely be volatile.



In my scan of prognostications for 2008, I found an article written by Dr. Paul B. Farrell who is a regular columnist for CBS MarketWatch and has written several books on investing, including *The Winning Portfolio*

and *The Millionaire Meditation* (perhaps an effective way of dealing with all of the bad news in the world). In his December column, Farrell predicted the US would experience a recession, due to the housing and credit crisis, and that stocks would enter into a bear market rivaling the 2000-2002 Tech Wreck period. While this was one of the more pessimistic predictions I found, nonetheless, he offered some sensible "resolutions" that investors might consider to better withstand the coming recession (my comments are in parenthesis):

- **Buy no-load index funds: No brokers, no active managers.** Protect your nest egg by investing in low-cost, no-load index funds. Research proves low expenses are the only reliable predictor of future performance. (We agree that active management is less reliable and more expensive, hence the reason why we build the foundation of our recommended portfolios upon passively managed funds)
- **Invest long-term: Market-timing is high-risk gambling.** Nobody can beat the market. Remember, about 75% of all managers fail to beat their benchmarks. They want you to play the market because they get rich from your trading fees and commissions (including asset management fees). If you have an itch to gamble, go to Las Vegas or buy a lottery ticket - the odds are higher and so is the entertainment value. (Ditto)
- **Rebalance: Focus on picking allocations first, not funds.** Once you determine exactly what asset allocations fit your particular needs, stick to them. Remember, the mix of specific indexes is crucial, not the specific funds. Rebalance when necessary to bring your portfolio in line. (Ditto, plus, rebalancing forces investors to act in a contrarian manner through the discipline of selling high and buying low)
- **Live with gratitude: Life is a gift (and so is your nest egg!).** Every day is an opportunity to be thankful for all you have. Share it with your loved ones, friends and those less fortunate around you in this wonderfully abundant world. (Ditto once again)

### Strategy for 2008

Over the past five years, our long-term investment strategy has introduced two important asset classes, Real Estate and Natural Resources, and has continued to evolve toward a more globally diversified allocation. In 2007, we introduced the "core" portfolio concept with the introduction of the DFA Vector Fund which provides a more efficient allocation among the three asset classes of Small Value, Mid-Value and Large Value. One of the benefits of the core approach is that fewer funds are required to provide the same asset allocation exposure thus driving down fees and providing greater tax efficiency for taxable accounts. We may be introducing a core fund in the international asset classes later this year and will continue to expand the foreign stock exposure with an eventual eye toward creating globally market neutral portfolios. We will also be redoubling our efforts to bring down the cost of portfolio management for our clients by moving into lower fee mutual fund share classes wherever possible and by replacing actively managed funds with passive alternatives whenever the active managers fail to consistently beat their benchmarks. Studies have shown that passively managed funds, such as those offered by DFA and Vanguard, provide more consistent results than their actively managed peers over the long-run, with their low cost being a major factor. Beyond these specific steps, we will continue to work with our clients in partnership to adjust their portfolios, as necessary, to meet their individual goals, objectives and risk tolerances.

I hope that you had an enjoyable holiday season and here's to greater peace and understanding around the globe in 2008.

Sincerely,  
Warner A. Henderson