

**2007 INVESTMENT COMMENTARIES:** 4th Quarter, 2007 in Review

For the most part, fourth-quarter returns were consistent with the rest of the year. Commodity prices moved sharply higher (PIMCO Commodity Fund), 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 (Thornburg, Artisan and Harbor Internationals) 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 (TCW and Harbor Capital) delivered decent positive returns for the full year. Small-caps continued to lag large-caps and were also in the red for the year. 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.

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 homebuilding 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 best action was overseas (PIMCO Developing Market Fund) as the dollar's drop gave U.S. investors currency gains that enhanced their returns.

For you, it was a year when each of the tactical asset allocation moves we made added value vs. the S&P 500. 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.

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, as well as Bill Miller at Legg Mason.)

So what matters most right now? Two things: the underlying economic and investment fundamentals and understanding what is reflected in current security prices.

There are other things that matter when it comes to portfolio construction, but with respect to assessing competing investment opportunities—which is what investing is all about—these two areas are where I focus my 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. One of the common failings of amateur and professional investors alike is thinking that they are smarter than they really are, i.e., overconfidence.

My investment decisions are always made based on a multi-year outlook. This allows me to focus on underlying fundamentals and valuations—the factors that ultimately drive returns—and distance myself emotionally from the day-to-day "noise" of the markets and the financial media. However, I am not totally unconcerned with performance over periods as short as one year because I manage all of your portfolios based on a targeted one-year loss threshold.

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 slam dunk. I am taking a close look at the risk exposure in your portfolios and assessing whether I should increase your defensiveness. Because the scenario analysis suggests that your portfolios can withstand a normal recession without violating 12-month risk thresholds, any moves I make are unlikely to be dramatic. 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. I've been surprised by positive market returns many

times over the years. So I 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 my eye on the more important goal of long-term returns.

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. 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. You will notice that I have allowed a large buildup of cash in your money market funds. The purpose is to have funds available should the markets recede even further and “buy low” when the opportunity arises.

I thank you for your business and your trust.

**Mullen Advisory, Inc.**

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