

MARKETPOINT



IN THE 1ST QUARTER OF THIS YEAR, the global markets awoke to the existence of risk.

Symptoms of a breakdown in the US sub-prime lending market started to surface in the quarterly reports of institutions that deal in these types of loans, unveiling the ugly realities of an over-stretched US consumer and a softening real estate market. Reacting to these developments (which were not new), global portfolio managers began the process of re-pricing their perception of risk by withdrawing money from those areas perceived to be the most vulnerable to a US-led slowdown and

the possible spread of "credit contagion." China was the first such market and its dramatic, well-publicized 9% one-day drop led to a follow-through smashing of asset prices across the globe, regardless of quality or long-term merit.

In our view, market participants are correct in their renewed perception of risk—a point we discussed in the *Winter* newsletter—but they are not correct that the same risk exists everywhere. Over the previous 5 years or so, an unsustainable growth in credit has led to certain assets being bid up to speculative levels. And further, high asset values themselves cause additional creation of credit. It is important to be aware of these negative factors, but also that risk is not created equally and differs significantly over time horizons. In the short term, it is a function of leverage, and in the long term, it is a function of over-inflated expectations.

Unfortunately, while governments can provide the liquidity (credit) into economies, they can't control where it ends up. In the recent past, much of it ended up in the pockets of private equity and hedge fund managers that assess extraordinary fees from their institutional clientele, who are clamoring for "alternative" returns in an era of 4.65% 30-year bonds. These fees then flow into luxury goods, private jets, artwork and cause feverish bidding of properties of high-end resort markets—which are all vulnerable to credit contraction despite pronouncements to the contrary from agents who facilitate transactions in these markets.

Because credit ebbs and flows like the tide, the current backdrop increases the importance of an acute focus on the downside exposure of investments. Moreover, it is prudent to be aware that, in the short-term, any investment can be affected by a change in perceptions, not just economics, and not to get emotionally caught up in volatility. Luckily, more volatile markets can present a greater universe of opportunities, allowing us to initiate or exit positions at distorted prices.

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IN THIS ISSUE

- Repricing of risk in global markets
- Importance of risk management and perspective in long-term investing
- *Extraordinary Popular Delusions and the Madness of Crowds*



Obermeyer

ASSET MANAGEMENT COMPANY

“Japan is coming off a 17-year deflationary recession and has worked through many of the bad debts that have plagued Japanese banks for years.”

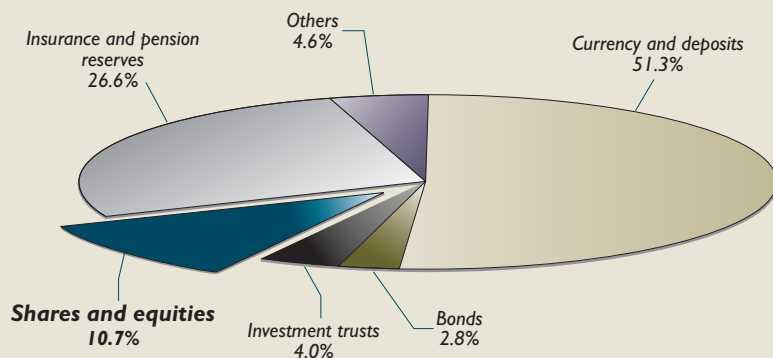
We expect a slowing in the growth of credit to precipitate a de-leveraging across global markets and this may or may not have begun in earnest in February. As such, we withdrew a portion of our clients' investments in Emerging Markets (fortunately just before the February sell-off). We consider the Emerging Markets sector to be an area where there is likely too much leverage (borrowed Dollars, Yen and Euro), and therefore, vulnerable to selling as global liquidity dries up. However, Emerging Markets is also an area that has fantastic long-term merit as global economies integrate further and production is outsourced to the lowest cost provider, so we continue to keep a portion for longer-term accounts.

We reinvested the proceeds from these sales into a fund that specializes in Japan. Japan is coming off a 17-year deflationary recession and has worked through many of the bad debts that have plagued Japanese banks for years. Moreover, the Japanese Yen is the liquidity source of choice for global investment managers at the moment and as markets de-leverage, the proceeds of those Yen-based loans are likely to flow back into Japan, bidding up asset prices there. At the same time, the Japanese government will probably keep the Yen as weak as possible without causing political tension with its neighbors, keeping profit growth strong for corporate Japan, a likelihood not strongly implied by existing valuations there.

JAPANESE HOUSEHOLDS

do not have much investment in their own stock market.

They have a long way to go to catch US households at 31%
% of Total assets worth 1,495 trillion Yen (12.8 trillion)



Source: Bank of Japan



While difficult to endure, the global financial markets needed the recent volatility to keep the overleveraged players in check given the abundance of liquidity in the markets. Looking forward, we anticipate further periods of market weakness as managers continue to reprice risk, but we are confident in our long-term investments and believe our clients are well-positioned to benefit from continued global economic development and ongoing demand for natural resources, even in the face of a slowing US economy. Our priority is to construct an opportunistic portfolio of investments with the least long-term risk possible. This is paramount to achieving favorable investment outcomes. ■

TOP OF MIND

HOW TO THINK ABOUT RISK

WHENEVER THE STOCK MARKET experiences any pressure, there is much gnashing of the teeth in the press about all the risks in investing. Yet this hype tends to be overdone and poorly-framed during these periods. While many investors think of “risk” as the volatility of their account balances, we at Obemeyer define “risk” as the possibility of permanently losing your investing dollars. In today’s environment of generally high asset prices, this is a very real concern, and is why we manage our clients’ portfolios with the goal of limiting an irreversible loss of capital.

Benjamin Graham, the famous value investor, was fond of saying that the essence of investment management is the management of *risks*, not the management of returns. Many managers, however, put too little effort into avoiding losses, and instead overly fixate on earning short-term gains.

Risk isn't something to fear; it is something to understand. Some risk is actually good, for the simple fact is that certain investments offer more long-term upside than

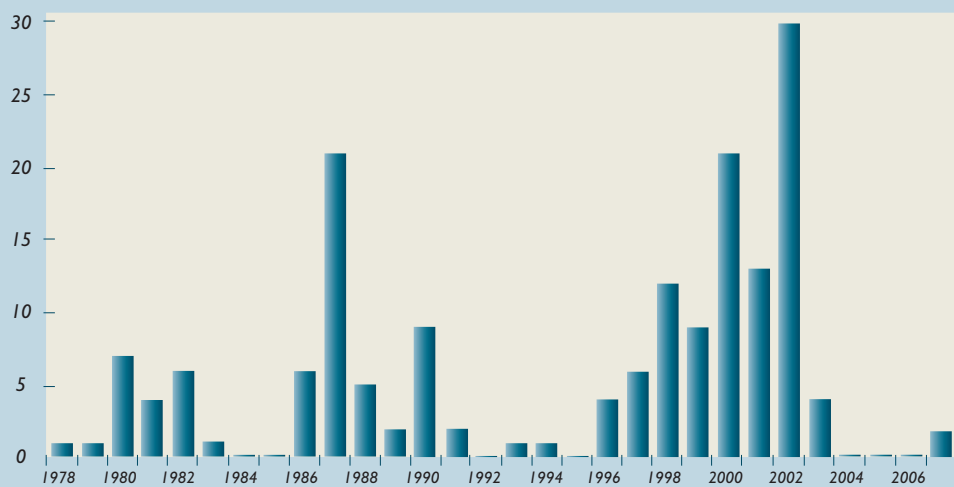
downside. Your goal shouldn't be to eliminate risk altogether, but to eliminate *uncompensated risk* and to only take *calculated, intelligent risks*. **This approach to risk management is the very crux of our investment philosophy.**

We pursue *intelligent risks* by thoroughly researching each investment we make, committing capital to **undervalued or mispriced assets** that are poised to benefit from evolving global trends, **diversifying portfolios** so no one investment can heavily skew results, and by **maintaining perspective** during difficult markets.

Perspective means knowing that investing is not an overnight phenomenon, but a long-term commitment, and when fear comes, being able to put it in context. In the graph below, each bar represents how many days the S&P 500 was down more than 2% during a calendar year. In 1998, there were 12 days, 2003 there were 4 days, and there were none in 2004, 2005 or 2006. We now have experienced two in 2007 (as of this writing), and if history is any indicator, more will likely come. **Volatility itself doesn't concern us.** We know that market declines go with the territory of owning long-term assets.

By selecting investments wisely and avoiding excess risk, we can remain levelheaded during periods of euphoria and despair. We view this temperament and perspective as being critical to stacking the odds in our clients' favor, and increasing your wealth in the long run. ■

NUMBER OF DAILY 2% DECLINES IN THE S&P



Source: Interactive Data Corporation

RECOMMENDED READING



OBERMEYER TEAM

(Pictured above, from left to right)

INVESTMENT COMMITTEE

Wally Obermeyer, President

John Goltermann, Vice President,
Director of Equity Research, CFA, CPA

Ali Flynn Phillips, Director of Business
Development

Roger Henefeld, Director of Fixed Income,
CFA

PROFESSIONAL STAFF

Sallie Klein, Client Services Manager

Chris Goodendorf, Operations Manager

ADVISORS and DIRECTORS

(not pictured)

Brad Zanin, Advisor

William Patterson, Director

Written in 1841, the lessons of *Extraordinary Popular Delusions and the Madness of Crowds* by Charles Mackay are as relevant today as they were 160 years ago. This book isn't about finance per se, but about **crowds** and how otherwise intelligent individuals lose all common sense when they get carried away in collective action.

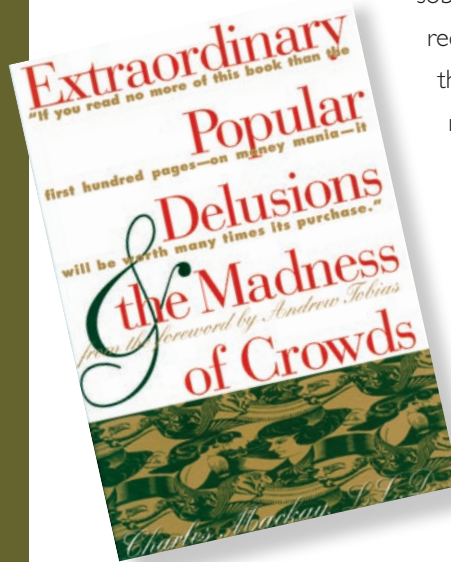
The author wittingly profiles historic tales of mass mania—ranging from alchemists and crusaders to witch hunts and hair & beard fashions in men. The most well known story is that of *Tulipomania*, which took place in Holland during the seventeenth century. During this bubble, speculators from all walks of life bought and sold tulip bulbs and even futures contracts on them. Allegedly, some tulip bulb varieties (including *Admiral Van der Eyck*) briefly became the most expensive objects in the world, until prices crashed to reality in 1637. While many

of these manias happened centuries ago, the reader quickly identifies the traits of "popular delusions" and soberly realizes that we have succumbed to them in recent years (for example: the high-tech boom of the late 1990s). The true lesson of this book is that mankind repeats its past mistakes with amazing regularity, and that we should keep this dose of history close at hand the next time we feel the crowd is running in the opposite direction of reason and logic.

This book is highly recommended as a must read for any investor or student of human behavior. It, however, is probably best digested in stages as it is a lengthy 700+ pages, but to quote the economist Andrew Tobias, "if you read no more...

... than the first hundred pages—on money

mania—it will be worth many times its purchase." Please let us know if you would like a copy of this book. ■



Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels.

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