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Introduction:

We hope our subscribers had a wonderful Holiday Season at the end of 2007. With 2008 Alphareturns will be making some changes to our newsletter and website. The quarterly newsletter will be organized with an executive summary at the beginning. This executive summary will give our assessment of economic and market conditions in a concise format. The executive summary will then be followed by our model portfolio allocations for the upcoming quarter. Last but not least, we will have a detailed discussion of global economic conditions for those of you who are interested in a more technical detailed analysis. The Alphareturns.com website will have a model portfolio performance chart on the homepage so that you can log on every day and check out the year to date performance of each portfolio as of the prior day's close. The website will also have a weekly commentary updated each Friday after the market close. This weekly commentary will give our weekly observations on the week's economic and market news. These changes are coming as the result of valuable feedback from clients. Please keep the constructive comments coming! We always welcome the chance to implement feedback in a way that makes our website and newsletter better.

Executive Summary:

- 2007 ended with the market exhibiting nervous volatility due to increasing stress in the financial and real estate sectors. Even with this turmoil, the Alphareturns model portfolios beat the S&P500 by more than 3 percentage points while averaging less than half the volatility. Our Conservative, Moderate, and Aggressive Model Portfolios returned 7.74%, 7.69%, and 7.58% respectively for the year ended December 31, 2007 compared to the S&P500's return of 3.53%. Wise diversification in all of our portfolios created superior performance with considerably less risk and volatility than the broad market (see 2007 performance discussion below).
- Our economic forecast for 2008 calls for a significant slowdown in the US economy with GDP (gross domestic product) growth falling from 2.2% in 2007 to 1.5% in 2008 and a mild recession occurring mid-year. Euro-zone GDP growth is also forecast to fall from 2.5% to

1.8% in 2008 while Asian economies are expected to slow from 4.7% to 4.2%. When Japan is excluded from the Asian GDP forecast, Asian growth ex-Japan is expected to be a point higher at 5.2%.

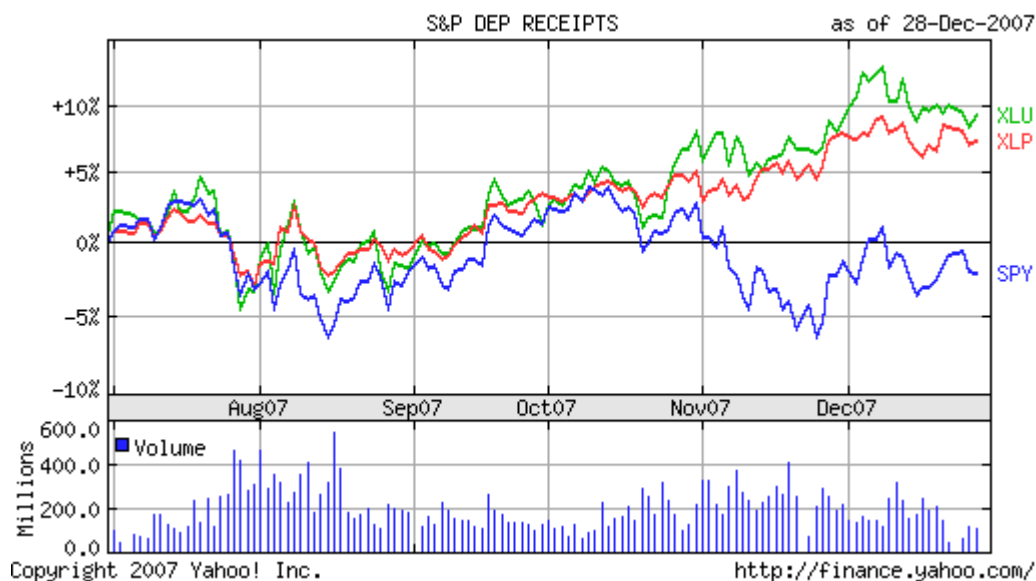
- In spite of the slowdown in global GDP, global consumer price inflation is expected to hold constant at around 2.7% during 2008. Demand weakness in the US and Europe will be offset by demand from Asia and rising food and energy prices worldwide. When Japan is excluded, global inflation will be north of 3%. Even though cpi inflation is expected to be moderate during 2008, we expect the dollar to continue its decline against other major currencies. During 2007 the dollar index as reported by the Wall Street Journal declined in excess of 7%. In 2008, we expect the dollar to decline more against Asian currencies than the Euro and we expect gold to increase in price as well.
- Current major developed stock market valuations appear to be reasonable with the S&P500 at 17 times earnings, Europe at 15 times earnings, and Asia (ex-Japan) at 15 times earnings. However, we are still very cautious regarding stocks in 2008. We believe that the global financial credit crisis and GDP slowdown will hurt corporate earnings more than analyst expect in 2008. We continue to believe that Wall Street analysts are chronically too optimistic with regard to corporate earnings growth for 2008. Already we have seen analyst estimates for 4th quarter 2007 S&P500 earnings slashed from 12% to 3% as the financial sector's earnings plummeted due to the credit crisis. This means that these attractive P/E valuations will not look so good by the end of 2008 when we find that the earnings part of P/E is lower than expected. Therefore, our portfolios will be defensive going into 2008 with much less exposure to stocks and more exposure to global treasury bonds and commodities. The limited stock exposure will be biased toward consumer staples and utilities in the US and International markets. Historically consumer staples stocks (companies engaged in selling food, tobacco, beverages, and personal hygiene products) and utilities perform better in economic downturns. We expect Asia (ex-Japan) to weather the coming economic storm better than the US, Europe, and Emerging Markets. Our stock holdings will also be weighted more toward large cap as opposed to small cap type stocks. As mentioned before, in times of economic distress, large companies tend to outperform small companies. When the real estate and financial sector crisis subsides and economic growth picks up again we will then move back into small caps. Our historical overweight of value style stocks will also be put on hold for a while in 2008 as most value style indexes are heavily exposed to the real estate and financial sectors. We still view financial and real estate stocks as value traps at this time (see model portfolio allocations for Q1 2008).

The Alphareturns Model Portfolios for Q1 2008:

Because of the likelihood of recession and lower corporate earnings in the US economy, we will make adjustments in our model portfolios to take a more defensive posture going into 2008. In summary we will substantially reduce our exposure to US stocks down to a small allocation in US consumer staples and utility stocks. We will also reduce our exposure to International stocks. The table below details the model portfolio allocations we are recommending for the first quarter of 2008. We will briefly touch on the rationale behind the various asset allocation choices:

Metals and Mining Stocks: The US dollar index as reported in the Wall Street Journal lost over 7% in 2007. This helped all commodities increase in value since they are denominated in US dollars. We continue to see increased interest in gold as a reserve asset for central banks. In addition to gold, we want to maintain our exposure to metals commodities including steel, aluminum, enriched uranium, copper, titanium, and other metals. We believe the declining US dollar and global GDP growth in the 3% range will continue to favor companies involved in mining precious and industrial metals. To participate in this sector we are staying with the SPDR S&P Metals and Mining Index exchange traded fund (symbol XME). Additionally, this quarter we are recommending a move back to the gold bullion exchange traded fund (symbol GLD) and a move out of the gold mining fund (symbol GDX). The GDX gold mining fund is not tracking as well as we would like with regard to the increase in bullion price. Therefore we will go back to gold bullion with the GLD fund to start 2008.

US Stocks: With our cautious posture regarding the threat of recession in the US, we will move out of the Vanguard US Value fund and into the US Consumer Staples and US Utilities ETF funds with respective symbols XLP and XLU. Historically consumer staples and utility stocks have outperformed the broad market during recessions because consumers still buy the staples they need (food, beverages, personal hygiene, tobacco, etc) and utility services even in bad economic times. In fact, as the US market started to show signs of weakness in late 2007, the XLP consumer staples and XLU utilities funds continued to advance upward (See chart below). We see large institutional investors getting very defensive in 2008 and they are already moving allocations into consumer staples and utilities.



Utilities (XLU) and Consumer Staples (XLP) outperform S&P500 (SPY) late in 2007

Source: Yahoo Finance

International Stocks: International stocks in emerging markets, Japan, and Europe are likely to be hurt by the slowdown and possible recession in the US economy during 2008. Asia (ex-Japan) is forecast to have stronger GDP growth than the US during 2008 and should avoid recession even as the US struggles. Following our sector bias toward consumer staples and utilities, we will diversify internationally with three exchange traded funds: Global Consumer Staples ETF (symbol KXI),

Wisdom Tree International Utilities (symbol DBU), and Ishares MSCI Pacific ex-Japan (symbol EPP). For 2008 we will exit the Australian fund (symbol EWA) and EAFE Value Index fund (symbol EFV) due to our cautious view of the global economic situation in 2008. We still have a reasonable degree of exposure to value style and Australian stocks through the KXI, DBU, and EPP funds. As with the US market, International consumer staples and utilities outperformed the broad MSCI EAFE market during the market turmoil late in 2007 (See chart below).



Int'l Utilities (XLU) and Consumer Staples (XLP) outperform EAFE (EFA) late in 2007

Source: Yahoo Finance

Emerging Market and Foreign Small Cap Stocks: With the overheated stock market situation in many of the emerging markets, we are maintaining our overvalued call on emerging market stocks. We see most large institutional investors decreasing their exposure to emerging markets and small caps for 2008. As global GDP growth slows down, valuations for foreign small/mid cap stocks in developed markets also look stretched. We will exit our allocation to all small cap stocks until the global slowdown ends and growth resumes. Emerging and small cap stocks have historically underperformed during times of economic stress. Even though Chinese and Indian stocks continued to perform well during 2007, we still believe the Chinese and Indian markets are overvalued and too risky at this time. Chinese stocks started to trade down during the last few months of 2007 and we believe Chinese stocks will trade down or sideways during 2008.

Fixed Income: As forecasted in our previous newsletters, the credit crunch and re-pricing of risk in the credit markets is resulting in a steeper yield curve. Therefore we are still recommending Short Term 1 to 3 Year Duration US Treasuries with the SHY exchange traded fund. We forecast short-term rates to fall as US GDP growth slows in 2008. Fed funds futures are forecasting US Fed rate cuts into the 3.5% range from the current 4.25% level by the summer of 2008. In addition to the SHY short term treasury allocation, we are increasing our overall bond allocation by adding two new funds for 2008: the Long Term US Treasury fund symbol TLO, and the International bond symbol BWX. As the US approaches recession and the global economy slows during 2008, central banks should lower rates causing bonds both in the US and abroad to increase in value. Long term

US treasuries should increase in principal substantially due to rate cuts and International bonds should increase in value due to rate cuts and the weak dollar.

Natural Resources: We are standing firm on our allocation to the natural resources sector because we believe the falling US dollar and energy supply issues will continue to favor companies involved in the natural resource sector. Energy companies involved in oil, refining, and natural gas are especially attractive. To achieve a broad diversification in this sector we will continue with an allocation to the Ishares S&P GSSI Natural Resources Index exchange traded fund (symbol IGE).

Alphareturns Model Portfolio Allocations For Q1 Calendar 2008:

Symbol	Asset Class	Conservative Risk 1-3 year horizon	Moderate Risk 4-7 year horizon	Aggressive Risk 7+ year horizon
XLU	US Utility Stocks ETF	2%	3%	4%
XLP	US Consumer Staples Stocks ETF	3%	5%	8%
KXI	Global Consumer Staples Stocks ETF	3%	11%	22%
DBU	Int'l Utility Stocks ETF	2%	3%	4%
EPP	Asia Pacific ex-Japan Stocks ETF	5%	15%	25%
SHY	1 to 3 year US Treasury ETF	40%	30%	15%
TLO	Long Term US Treasury ETF	12%	8%	4%
BWX	Int'l Treasury Bond ETF	15%	10%	5%
GLD	Gold Bullion ETF	10%	7%	5%
IGE	GCSI Natural Resources ETF	5%	4%	3%
XME	Metals and Mining Stocks ETF	3%	4%	5%

Q4 2007 Performance Discussion:

During 2007 our model portfolios outperformed their respective benchmarks for the full calendar year as well as during the 4th quarter (see table below). During Q407, our Conservative Portfolio returned 0.10% vs its benchmark of -0.78%, our Moderate Portfolio returned -1.23% vs its benchmark of -1.94%, and the Aggressive Portfolio returned -2.41% vs its benchmark of -2.80%. The Moderate and Aggressive Portfolios returned losses in the 4th quarter due to their higher exposure to stocks. However, as indicated by the data below our portfolios lost less than their respective benchmarks and also lost less than the broad S&P500 index.

For the full year ended 12/31/07, our portfolios outperformed their respective benchmarks by a wide margin. The Conservative Model Portfolio returned 7.74% YTD vs its benchmark of 4.89%, the Moderate Model Portfolio returned 7.69% YTD vs its benchmark of 4.81%, and the Aggressive Model Portfolio returned 7.58% YTD vs its benchmark of 4.74% (see performance table below for details). With regard to risk, our portfolios averaged approximately one half the volatility of the S&P500 when calculated on a quarterly standard deviation basis.

<u>Model Portfolios →</u>	Conservative Risk 1 to 3 year horizon	Moderate Risk 4 to 7 year horizon	Aggressive Risk 7 + year horizon
Q1 2007	2.47%	2.80%	3.07%
Q2 2007	3.49%	4.57%	5.60%
Q3 2007	1.50%	1.42%	1.28%
Q4 2007	0.10%	-1.23%	-2.41%
2007 ending 12/31/07	7.74%	7.69%	7.58%
<u>Benchmarks →</u>	50% Stock S&P500, 50% Bonds L.A.B.*	70% Stock S&P500, 30% Bonds L.A.B.*	85% Stock S&P500, 15% Bonds L.A.B.*
Q1 2007	1.01%	0.87%	0.77%
Q2 2007	2.83%	4.25%	5.32%
Q3 2007	1.78%	1.64%	1.53%
Q4 2007	-0.78%	-1.94%	-2.80%
2007 ending 12/31/07	4.89%	4.81%	4.74%

*Note: Bond portion of the benchmark is based upon the Lehman Aggregate Bond Index (L.A.B.)

Detailed Global Economic Technical Analysis and Outlook:

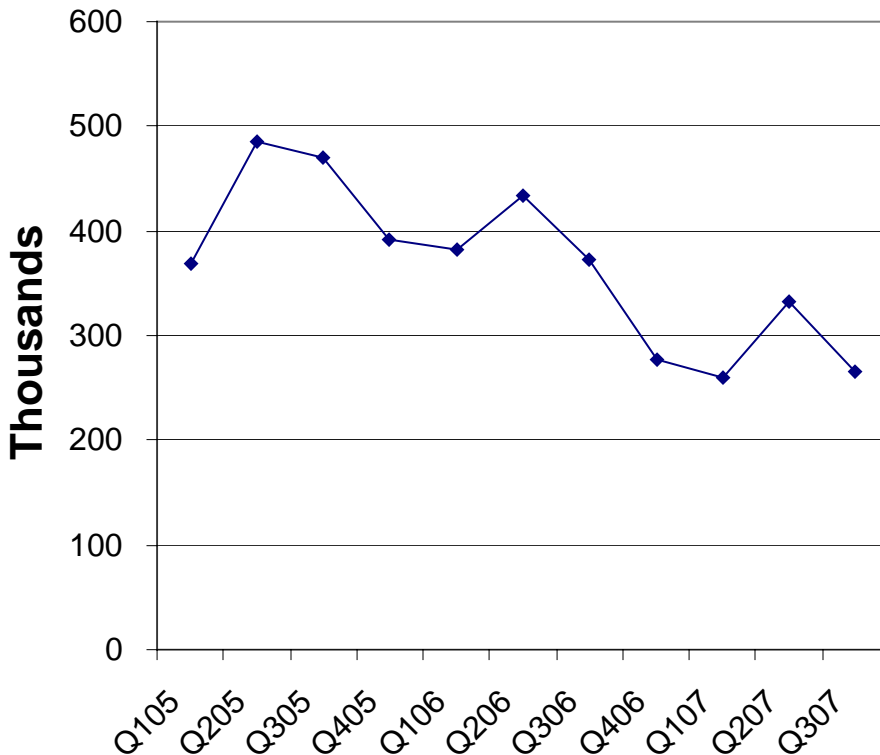
As 2007 ended, the world's financial markets continued their volatile gyrations. Problems continued to grow in the battered real estate and financial sectors of the US market. During the 4th quarter, credit problems in the US financial sector started to spillover to markets in Europe and Asia. The US government and Federal Reserve tried to create programs to rescue subprime mortgage holders and investors in troubled debt. Even with the temporary optimism of this government action, the markets remained nervous and skeptical as 2007 ended. Many economists increased their forecasts for a US recession in 2008 due to the increased risk that the financial sector's credit problems will impact consumer spending and cause the US and Global economies to slow and possibly contract. At Institutional Investment Research and Alphareturns we believe a mild US recession is likely to occur in 2008. We see stress in the world's banking system that rivals the savings/loan crisis and Japanese economic implosion of the late 80's and early 90's.

US real estate sector continues to weaken:

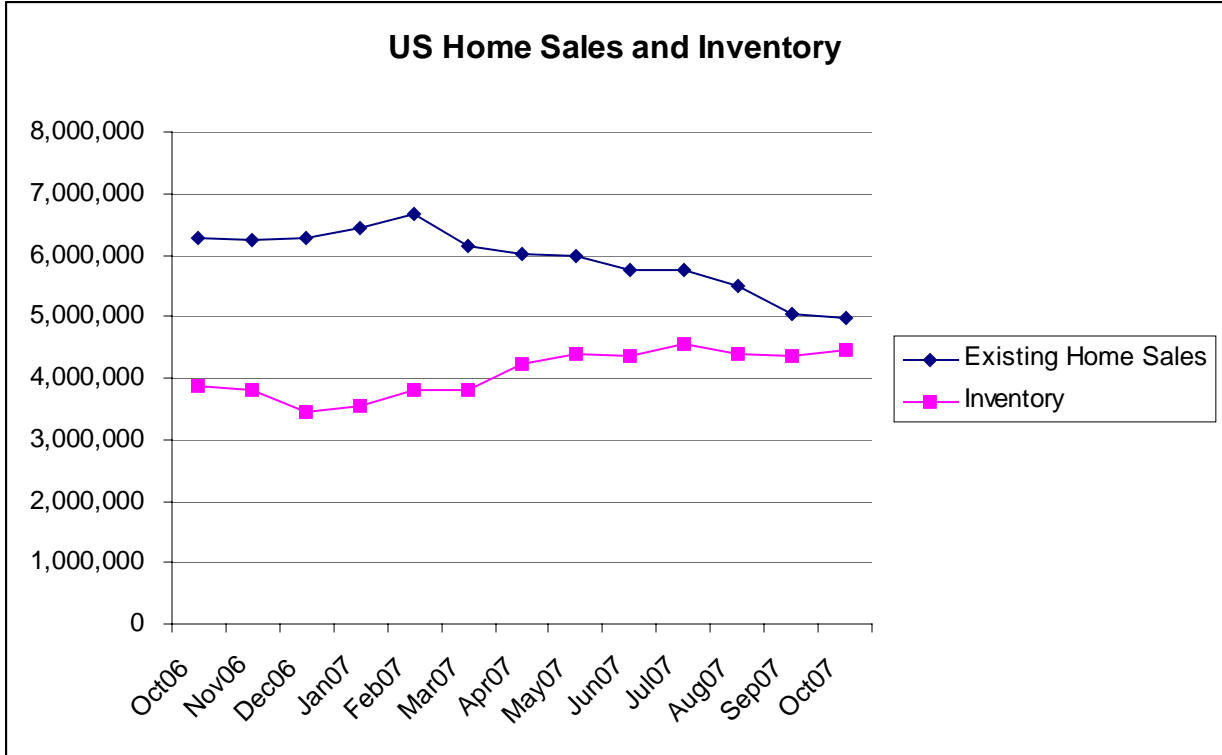
The re-pricing of risk in the financial sector and weakness in the real estate sector are poised to get worse in 2008. Hedge funds, mortgage companies, and banks announced stunning losses

associated with mortgage portfolios during August and then again announced even more so-called “unanticipated” losses in October. Even with these announced losses, our research shows that there may be an additional \$150 billion to \$300 billion in losses yet to come. The peak of mortgage defaults and foreclosures will occur in 2008 and this will trigger further losses in the financial sector. Consumers are already in more debt than ever and no longer have the ability to tap into home equity as home prices continue to fall. This second-wave of bad news will create substantial headwinds for global stock markets in 2008. The government’s program to reduce foreclosures is also likely to be too little too late in that it will only help around 200,000 homeowners in a market that is forecast to have 2 million foreclosures. The other issue with the program offered by the Fed and Treasury is that these programs are not mandatory. The programs so far require the mortgage servicers and investors to voluntarily modify sub-prime loan terms to benefit the mortgage holders and delay foreclosure. Each loan has to be reviewed and modified on its own terms, creating a mountain of administrative work for a mortgage industry that is currently shedding employees by the thousands. Housing starts are falling sharply but inventories of unsold new and existing homes continue to rise. High inventory supply and weak demand are causing median home prices to fall year over year for the first time since the Great Depression (see charts below).

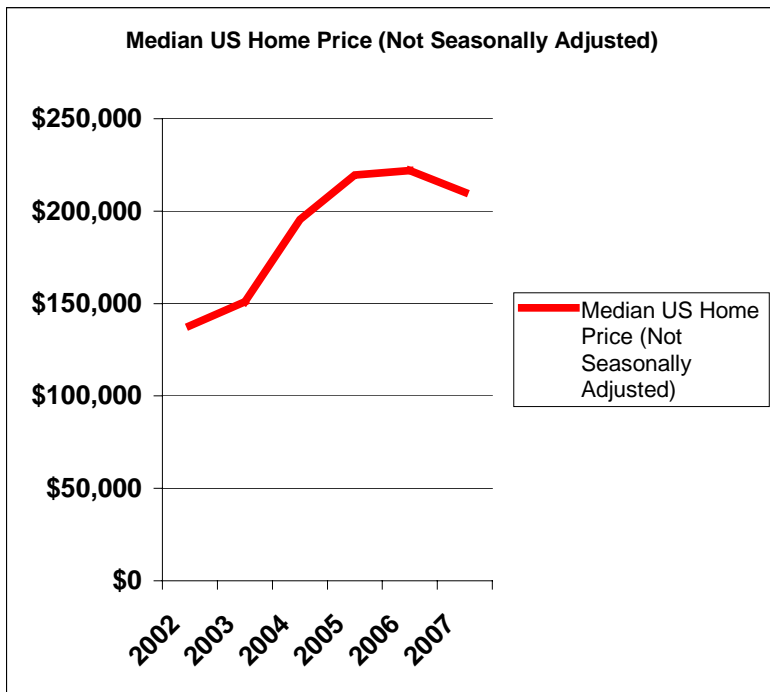
US Single Family Housing Starts



Source: US Census Bureau



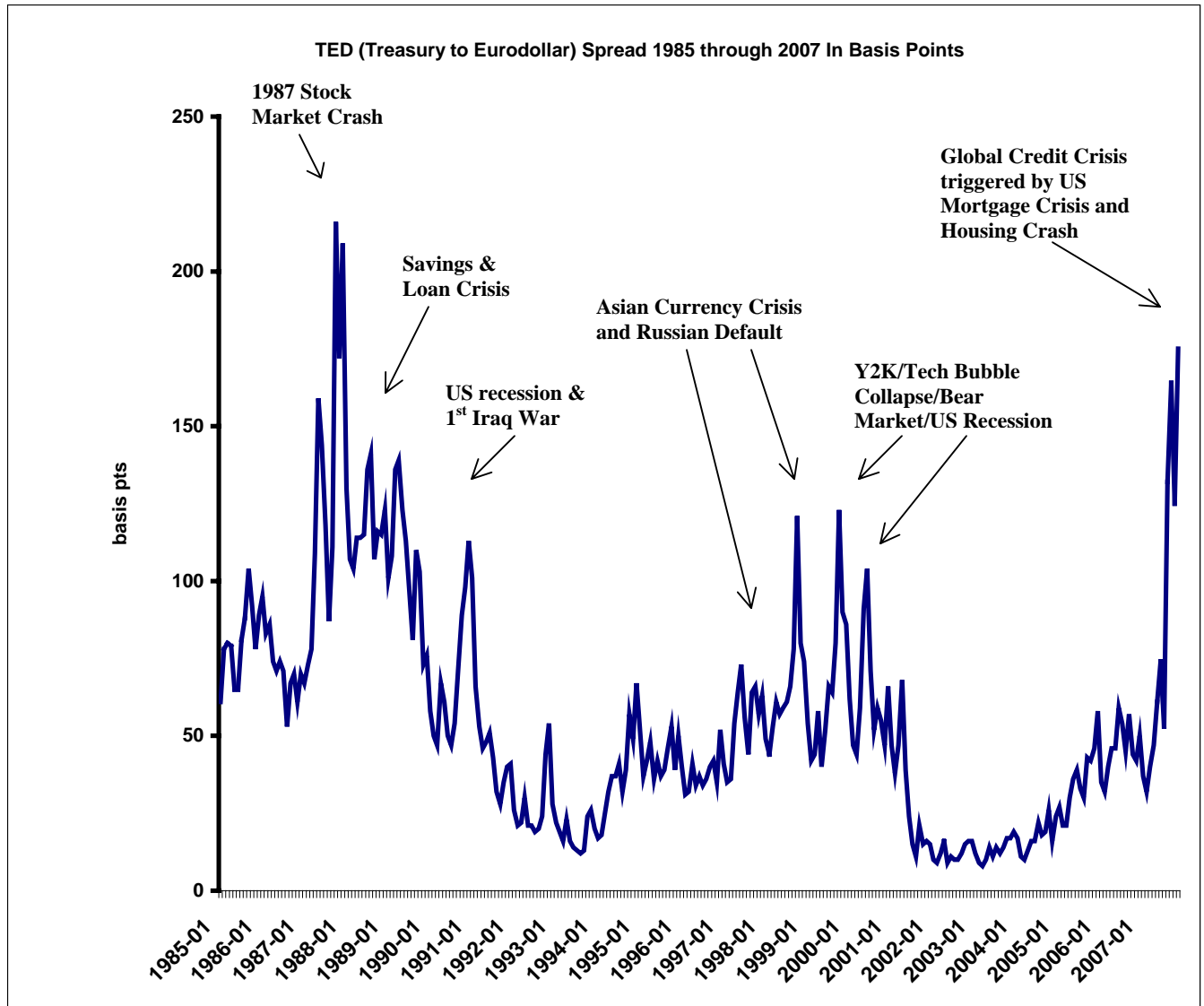
Source: National Association of Realtors



Source: National Association of Realtors

Global Credit and Financial Crisis Will Get Worse in 2008:

The global credit bubble we have been talking about since January of last year has finally turned into the global credit crunch. As we discussed in previous newsletters, the lowest interest rates in a generation, liquidity created by derivatives, deficit spending worldwide, poor mortgage and corporate lending standards, and a global housing boom caused a bubble in credit and debt issuance. This bubble is now officially deflating as debt markets re-price risk and the financial sector starts dealing with credit defaults and foreclosures. Credit spreads are finally starting to widen back to more historical levels as credit risk gets priced more accurately.



US Treasury to Eurodollar Libor Rate “TED” Spread Differential As An Indicator of World’s Financial System Stress - TED Spread is now at levels we haven’t seen since the ’87 Crash

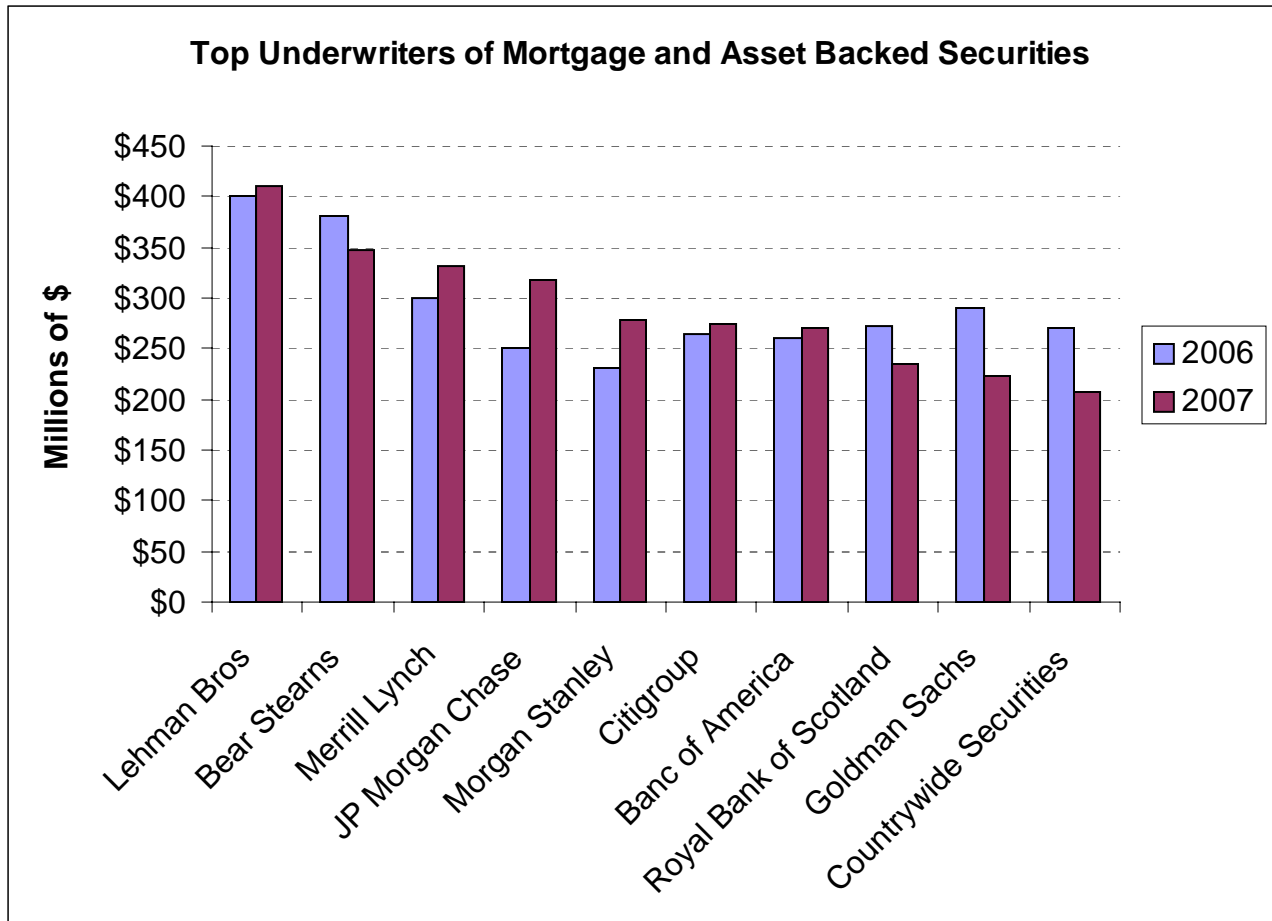
Source: BBA (British Banker’s Association) and US Federal Reserve Bank

As you can see from the chart above, the TED spread is warning of extreme stress in the world's financial system...stress unlike anything we have seen since the October 1987 stock market crash. In a recent Wall Street Journal article featuring an analysis of the current mortgage/housing induced credit crisis, the Journal reported that this current crisis rivals the Savings and Loan Crisis in magnitude. Our analysis goes further and predicts that losses this time around will be \$200 billion to \$300 billion compared to losses of \$150 billion from the Savings and Loan Crisis of the late 80's. So far we have seen bank loss write-downs in the \$70 billion range (See table below) which leads us to believe we will see many more large write-downs in 2008.

UBS	\$13.7 billion
Citigroup	\$14 billion
Morgan Stanley	\$10.3 billion
Merrill Lynch	\$8.4 billion
HSBC	\$3.4 billion
Bank of America	\$3.3 billion
Deutsche Bank	\$3.1 billion
Barclays	\$2.7 billion
Royal Bank of Scotland	\$2.6 billion
Bear Stearns	\$1.9 billion
Credit Suisse	\$1.9 billion
JP Morgan Chase	\$1.6 billion
Goldman Sachs	\$1.5 billion
Wachovia Bank	\$1.1 billion
Lehman Bros.	\$0.8 billion
Total=	\$70.3 billion

Note: Since Q3 2007

In addition to more mortgage related write-down in 2008. We also expect a tidal wave of litigation to hit the financial sector in 2008 as regulators and shareholders uncover legal issues related to the home appraisal and mortgage origination/securitization process. There are already a number of suits filed and investigations underway related to the way banks collaborated with ratings agencies to gain AAA ratings on pools of sub-prime mortgage debt. As the sub-prime debacle started to unfold these ratings agencies quickly cut their ratings on sub-prime debt securities from AAA to junk status. As was the case in the savings and loan crisis of 20 years ago, we expect to see legal issues pertaining to inflated property value appraisals as foreclosures occur and properties are sold. Litigation and criminal charges similar to the tech stock analyst scandals of 2001 and 2002 are just around the corner as the real estate/credit bubble implodes. We also expect to see legal trouble for banks that attempted to move their sub-prime exposure off their balance sheets to third party entities called Structured Investment Vehicles (SIV's). Citigroup recently had to move \$49 billion worth of sub-prime exposure back onto its balance sheet after its sub-prime SIV's suffered losses. At one point Citigroup, Banc of America, and JP Morgan Chase were trying to get other banks to help them set up a "Super-SIV" to bail out SIV's created since 2005. With legal/regulatory scrutiny increasing and little interest from other banks, this "Super-SIV" plan was scrapped by mid-December. The chart below shows the top underwriters of mortgage and asset backed securities.

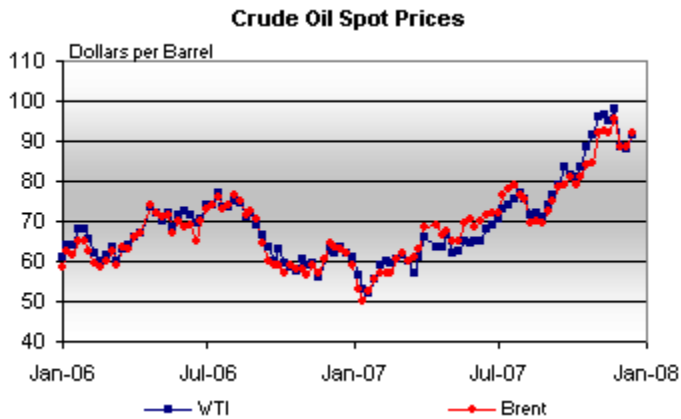


Source: Institutional Investor Magazine

In the savings and loan crisis of the late 1980's, US financial sector stocks traded below book value. Currently the US financial sector is trading at 1.5 times book value. We would not be surprised to see financial stocks trade below book value again before this credit crisis is over. When the banking system is in crisis, there is usually a substantial reduction in lending as banks lend less to shore up their capital base. The financial sector comprises 18% of the S&P500 and therefore is the single largest industry component of the US market by market capitalization. The continuing deterioration in this sector along with real estate (housing, construction, durable goods) will create substantial headwinds for US and global markets in 2008.

Oil and Energy:

As we have predicted all year, crude oil continues to price well north of \$60 closing at \$96 per barrel at the end of 2007. Iran continues to thumb its nose at the international community and forge ahead with its nuclear ambitions. OPEC, geopolitical risks, and a declining dollar should keep oil prices well above \$60 per barrel during 2008. However, we would not be surprised to see oil prices moderate and actually decline into the \$60 to \$80 range due to the global economic slowdown in 2008. During 2007, the allocation in our portfolios to the GSSI Natural Resources Index returned over 33%. We will still keep an allocation to natural resources, but do not expect the returns to be quite as high in 2008.



Source: EIA (Energy Information Association)

US Dollar in Decline:

As discussed in our previous newsletters, the US Dollar continues to lose its value relative to other currencies with the US Dollar Index (as reported in the Wall Street Journal) losing just over 7% during 2007. Dollar weakness and global demand for commodities are causing price increases in most commodity sectors. Gold gained 31% during 2007 as the dollar declined and demand increased for gold as a safe haven investment. As the US economy stalls in 2008, rate cuts by the US Federal Reserve should cause the dollar to weaken further as it decreases the yield advantage of the dollar relative to foreign yields.



US Dollar Index Weekly Closing Value from 2006 to Present

Source: FXStreet.com

Inflation Outlook:

Regarding consumer price (cpi) inflation, our research position has not changed significantly since the last newsletter. Global money supply growth is leveling off and we have inflation in the world's major economies comfortably below 3%: US= 2.2%, Eurozone= 1.9%, Australia 2.5%, Canada 2%, UK=2.5%, Japan=0%. As global GDP growth slows from a forecast of 3.9% in 2007 to an expected 3% in 2008, consumer price inflation should stay calm. Many economists are discussing the possible inflationary effects of the central bank actions and the US Federal Reserve's recent rate cut. As discussed earlier, these central bank actions were taken to stabilize the global credit markets in the wake of the recent credit market turmoil. We do believe that more rate cuts are coming and these cuts have the potential to cause increased inflation. However, it is more likely that rate cut induced inflation will be offset by housing and financial asset deflation. Our benign consumer price inflation forecast is not at odds with our investment allocation to commodities because we believe commodity prices are now driven more by dollar devaluation than by consumer price inflation.

Conclusion:

As previously discussed, 2008 is likely to be a year for caution and defensive investing. At Institutional Investment Research, we see many of the world's best institutional investment professionals making defensive moves to protect their clients' portfolios. Through the Alphareturns model portfolios we hope to provide timely research and ideas to help the individual investor make wise institutional level portfolio decisions. Our performance in 2007 proved the merit of our research and investment philosophy. As we begin 2008, we wish our clients all the best in the year ahead... *Happy New Year!*

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