



INSTITUTIONAL INVESTMENT RESEARCH, LLC

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Global Economic Overview and Outlook:

As we discussed in our Q1 2007 newsletter, the US economy continues to slow with sluggish GDP growth in the first quarter expected to come in at around 1% or less. Both residential and commercial real estate continue to weaken as leverage in both sectors shows signs of trouble on the low credit quality end of the spectrum. The OECD (Organization for Economic Co-operation and Development) forecasts GDP growth in the US to be 2.1% for calendar 2007 and 2.5% for 2008. There is still a slight risk of recession late in the year for the US economy if the housing market downturn worsens and consumer spending slumps further. While US stock market valuations do not look to be highly overvalued at this time, these valuations could look much worse if corporate earnings fall due to weaker than expected economic activity later in the year. We continue to tilt our portfolio stock weightings toward international stock sectors because of this potential US economic weakness.

While slow growth in the US will create headwinds for the global economy in 2007, growth in the Eurozone, Asia, and Latin America will keep the overall global economy expanding at a rate close to 3%. The 2007 forecast for Eurozone growth is 2.7%, Asia 4.2%, and Latin America 4.6% in real GDP terms. Many of these international markets are still selling at attractive valuations. The Eurozone's economy is growing faster than the US economy, yet Eurozone stock markets still have P/E ratios and price to cash flow ratios that are less than those for the S&P 500. In the Asia Pacific region we continue to favor the MSCI Australian stock index selling at a P/E of 14.5 and a dividend yield of over 4%. As of March, Australia has completely paid off all of its national debt and is enjoying the benefits of a 17-year economic expansion. Australia's economy is forecasted to grow at 3.2% this year and 3.4% in 2008. In Asia, we also favor Singapore and South Korea's stock markets due to strong economic growth and favorable valuations. Two Asia Pacific markets we are avoiding are Japan and China. Japan is still growing slower than the rest of the world and has an overvalued stock market P/E of 25. While China's economy is reported by its government to be growing at a blistering 11% pace, we believe the Chinese stock market is in a bubble and may not sustain its incredible run-up in value over the past 2 years. The China Stock 300 Index more than doubled in 2006 and is up over 50% so far in 2007 even after the 9% drop that happened in late February. Chinese P/E ratios are reported to be in the low 20's but we do not believe the earnings

data coming out of China and therefore view this data with a high degree of caution. Our calculations put the Chinese Aggregate Market P/E closer to 45. Stock market speculation by Chinese citizens and international hedge funds is driving this bubble to its inevitable conclusion. Similar bubble-like valuations in India, Russia, and Brazil have caused us to re-evaluate our emerging market stock exposure and recommend replacing our EEM emerging market stock ETF allocation with a much more attractively valued Wisdom Tree International Small Cap Dividend Stock ETF. The sudden drop in late February of the Chinese stock market certainly impacted the US and European markets during March. However, we believe that the potential unwinding of the emerging market stock bubble will have a muted impact on developed stock markets during the remainder of 2007. As mentioned earlier, we believe US small cap stocks are not quite as attractive relative to US large caps at this time. However, we do believe international small/mid cap stocks in developed countries are moving into our acceptable valuation zone.

Oil:

As we predicted in our Q1 2007 newsletter, crude oil continues to hover north of \$60 closing at \$65.87 per barrel at the end of Q1, up 7.9% year to date. Iran continues to thumb its nose at the international community and forge ahead with its nuclear ambitions. Also, the war in Iraq continues to descend into sectarian civil war. Therefore, we believe that the risks on crude oil are tilted toward prices being higher and staying above \$60 per barrel during 2007. With regard to gasoline prices, our research continues to point out a capacity shortage in the refining industry. This capacity crunch should keep refined gasoline prices high during the remainder of 2007. Refiners are currently running at well over 90% capacity and new capacity will not be coming on line anytime soon. Refiners in the US are still suffering from downtime caused by deferred maintenance that was mandated after hurricane Katrina by the US government.

US Dollar in Decline:

The US Dollar continues to lose its value relative to other currencies with the US Dollar Index losing 0.94% during Q1 and gold increasing in price by 4.38%. With the Dow Jones AIG Commodity Index up 3.28% in the first quarter, gold still looks like the most attractive commodity to own for now. We continue to hold gold through the GLD fund ETF in our model portfolios as a hedge against the falling US Dollar. Our international stock allocations also hedge our portfolios against the decline in the dollar. As the dollar falls, our international stock allocations increase in value relative to local currencies.

Global Credit Bubble and Inflation Outlook:

The lowest interest rates in a generation, liquidity created by derivatives, and deficit spending worldwide are causing a global bubble in credit and debt issuance. We have the lowest spread ever between high-risk junk debt and high-grade government debt (see Chart A below). Debt investors are taking on risk with little or no reward for credit or maturity as if there is no longer any risk in the fixed income market. One argument being floated on Wall Street is that risk can be hedged away with the use of complex investment instruments like derivatives and credit default swaps. We strongly disagree with this assumption and believe that credit spreads will widen back to historical norms as much of the junk and emerging market debt that is being issued goes into default. Chart B shows the convergence of yield (and thus imputed risk) for various US asset

classes. For the US stock market we used the forward 12-month expected earnings yield to compute the yield for the S&P 500. With an expected re-pricing of risk there may also be a “flight to quality” in the world’s stock markets, thus rewarding our patient value style investment principles. This should lead to a reversion back to higher interest rates on longer maturity, lower credit quality debt securities.

Regarding inflation, our research shows a closing of the global output gap (see Chart C). The output gap measures the world’s productive output vs its potential capacity for production. This simply means that labor, capital, and equipment are running at potential capacity such that further growth is likely to lead to inflationary pressures. A counter argument that has become popular on Wall Street is the notion that cheap labor from China, India, and Latin America will keep inflation low even as growth expands to stretch global capacity. While this is true and has been happening for the last few years, it is likely that we are approaching diminishing returns with regard to the low cost labor effect. The closing of the output gap will tilt the risk toward higher global inflation going forward. This growing inflationary threat is also behind the tightening of interest rates worldwide by central banks (see chart D).

Chart A: Credit Spreads:

Credit Rate Spread to US Treasuries
Source: Lehman Brothers

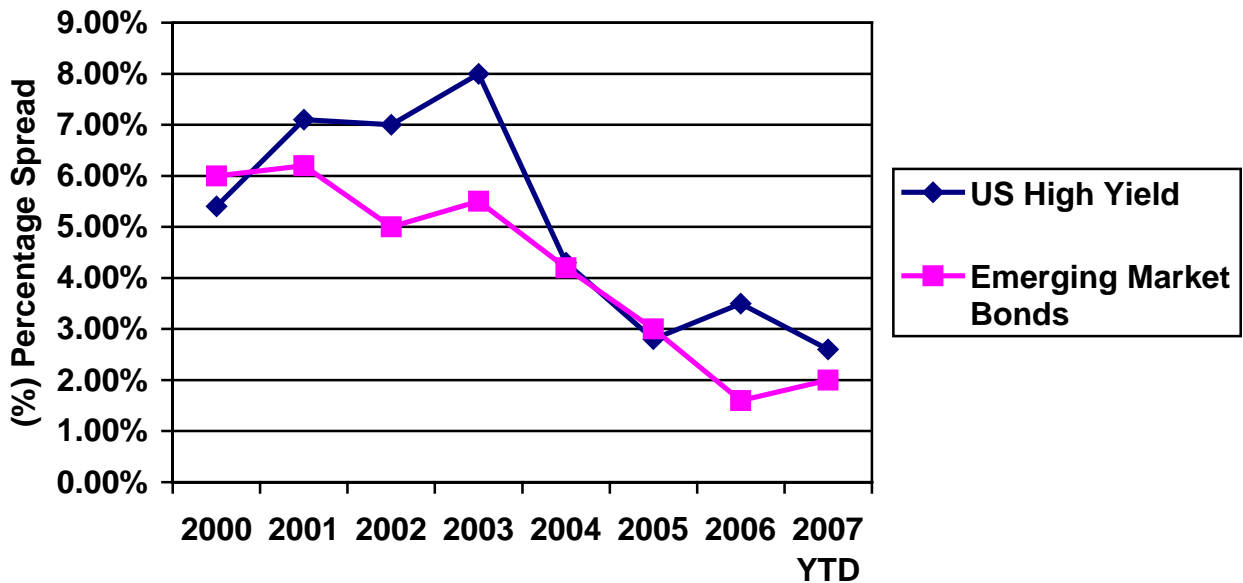
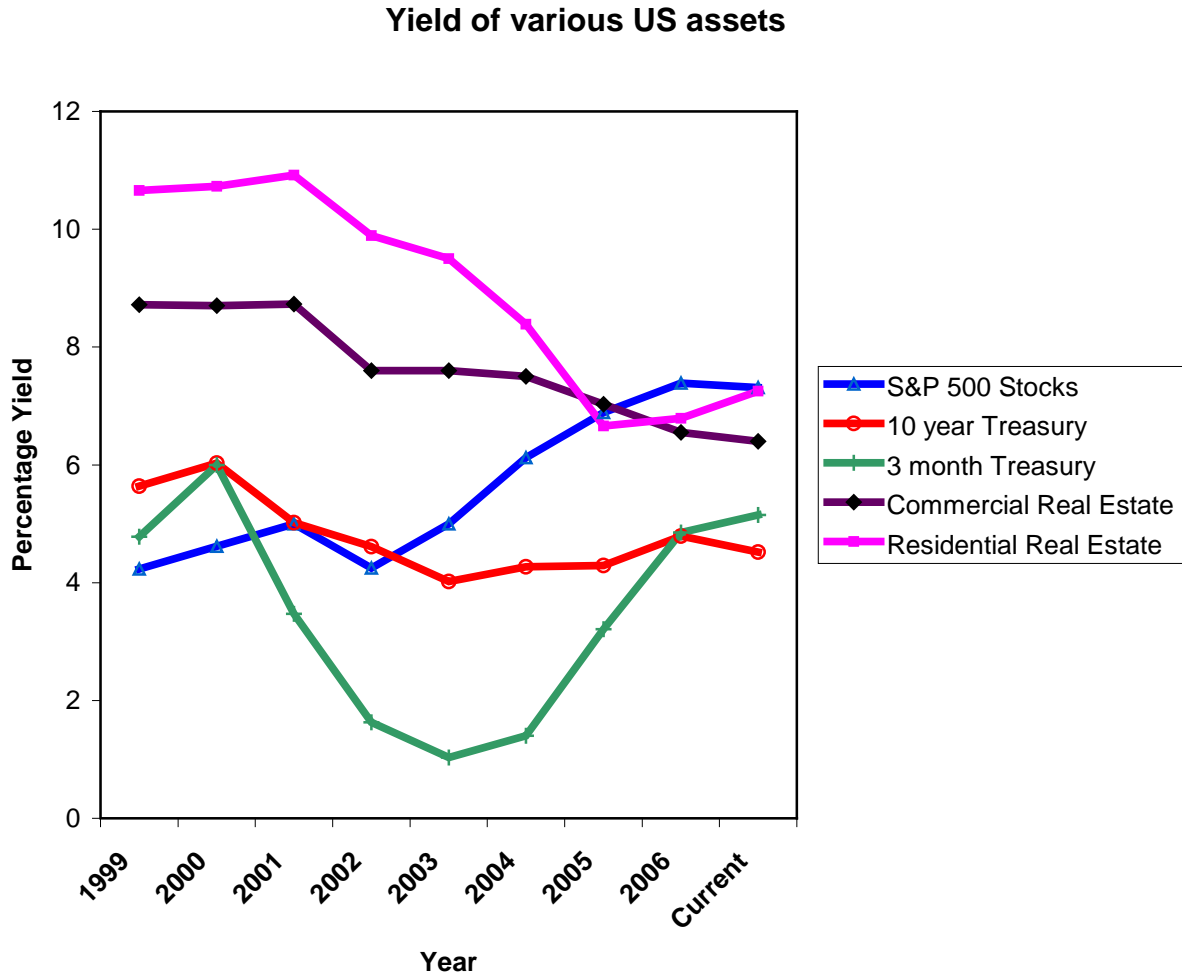
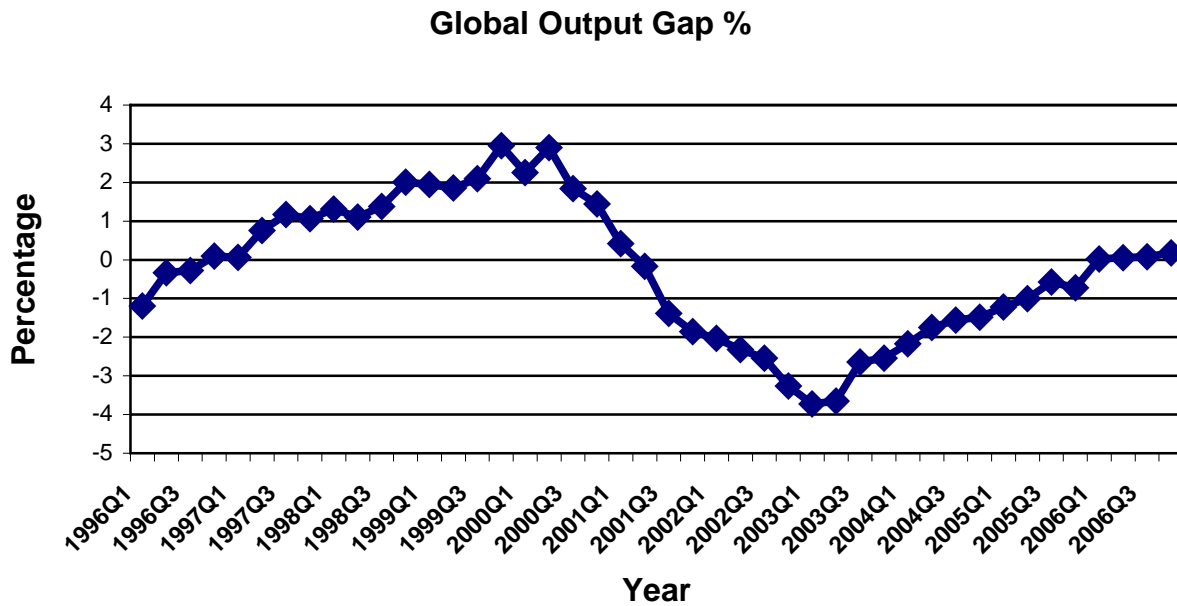


Chart B: Yield Convergence of Various Assets – Has Risk Converged?:



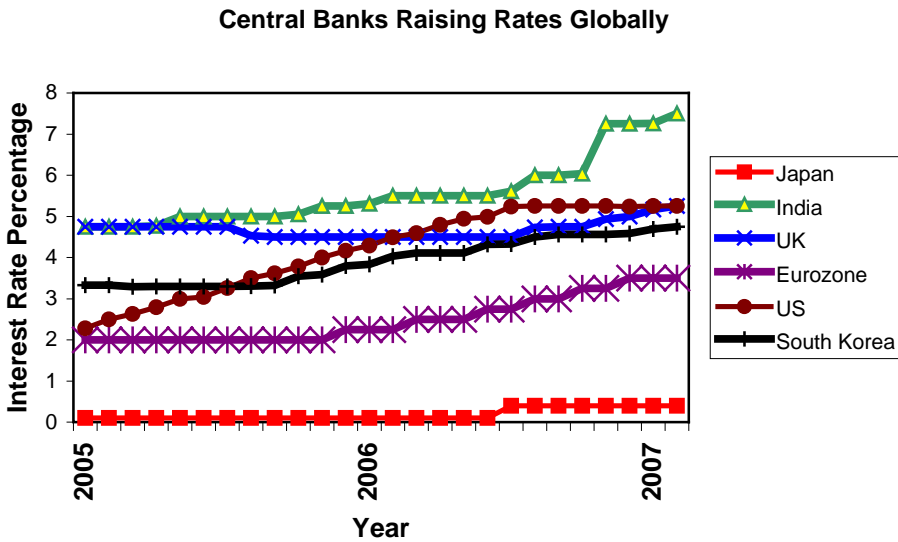
Source: Moody's Economy.com. Note: S&P 500 stock yield is forward earnings yield.

Chart C: Change in Global Output Gap Percentage:



Source: Moody's Economy.com. Note: Output gap measures the difference between production output and potential productive capacity of available labor, equipment, and capital.

Chart D: Central Banks Tightening Credit (Raising Rates) Globally To Fight Inflation:



Source: Moody's Economy.com.

The Alphareturns Portfolios:

The table below details the current portfolio allocations in the Alphareturns portfolios. We will briefly touch on the rationale behind the various asset class choices:

Gold: An investment thesis built upon the falling dollar, diversification, and the undervalued situation with gold. Our view is that gold is the most undervalued and attractive commodity to own at this time. We believe that central banks will diversify back into gold to escape losses due to the falling US Dollar. We also believe that gold's very low correlation with stocks will provide a hedge against volatility in stock markets.

US Value Stocks: Even though one of our key investment principles is the historical performance benefit of owning small/mid cap stocks vs large caps, at this time large cap value stocks are more attractive than small-cap and mid-cap value at this time due to valuation fundamentals. Even though US value stocks have outperformed US growth stocks over the past few years, they still have lower price to earnings, price to book, and price to sales ratios and higher earnings growth. Traditional US growth category stocks will also be hit harder by the expected slowing in GDP growth this year.

Foreign Large Value: Large International Value again looks attractive from a valuation standpoint and foreign stocks will also gain from the falling dollar trend. European stock markets look especially attractive due to lower price to earnings ratios and higher yields than US stocks. European GDP growth is still accelerating where US growth is now slowing.

Foreign Emerging Markets Stocks: With the overheated stock market situations in many of the emerging markets, we are now making an overvalued call on emerging market stocks and exiting our position in the EEM emerging markets ETF. We will replace this allocation with the international developed markets small/mid cap dividend ETF from Wisdom Tree investments (symbol DLS).

Asia Pacific excluding Japan: The Pan-Asian economies except for Japan and China are very attractive from a price to earnings and dividend yield standpoint.

Fixed Income: We believe that a re-pricing of risk in the credit markets will likely lead to a steeper yield curve. Therefore we have a higher allocation in Short Term Treasuries and a lower allocation in the Lehman Aggregate Bond Index. We forecast short-term rates to stay steady or fall as US GDP growth slows in 2007. However, as credit risk is re-priced in junk and emerging market bonds, we also expect longer-term bond rates to increase to more adequately reward investors for maturity risk.

Alphareturns Model Portfolio Allocations For Q2 Calendar 2007:

Symbol	Asset Class	Conservative Risk 1-3 year horizon	Moderate Risk 4-7 year horizon	Aggressive Risk 7+ year horizon
GLD	Gold ETF	5%	4%	3%
VTV	US Large Value Stock ETF	12%	15%	19%
VOE	US Mid-Cap Value Stock ETF	3%	5%	7%
VBR	US Small Cap Value Stock ETF	3%	5%	7%
EFV	International Value Stock ETF	12%	17%	22%
EPP	Asia Pacific ex-Japan Stock ETF	5%	7%	8%
DLS	Wisdom Tree Int'l Small Cap Dividend Stock ETF	5%	6%	7%
IEV	European Stock ETF	5%	6%	7%
EWA	Australian Stock ETF	4%	5%	6%
AGG	Lehman Aggregate Bond ETF	16%	10%	4%
SHY	Short Term US Treasury ETF	30%	20%	10%

Q1 2007 Performance Discussion:

During the first quarter of 2007 our portfolios outperformed their benchmarks by a wide margin (see table below). During Q107, our Conservative Portfolio returned 2.47% vs its benchmark of 1.01%, our Moderate Portfolio gained 2.80% vs its benchmark of 0.87%, and the Aggressive Portfolio gained 3.07% vs a benchmark gain of 0.77%. This was largely a result of the allocations to international stocks and especially stocks in the Eurozone and Asia Pacific/Australia regions. The Eurozone ETF symbol IEV was up 3.21% for the quarter, the Asia Pacific ex Japan ETF symbol EPP was up 7.27%, and the Australian ETF symbol EWA enjoyed a healthy 10.43% gain in Q1. Domestic markets were much more subdued after the late February sell-off triggered by the 9% drop in the Chinese market. Gold continued its advance with a gain of over 4% in the first quarter while our two bond ETF's produced a total Q1 return of 1.19%.

<u>Timeframe→</u>	<u>Conservative (1 to 3 year horizon)</u>	<u>Moderate (4 to 7 year horizon)</u>	<u>Aggressive (7+ year horizon)</u>
Q1 2007	2.47%	2.80%	3.07%
YTD 2007 ending 3/31/07	2.47%	2.80%	3.07%
Since Inception 1/1/07	2.47%	2.80%	3.07%
<u>Benchmarks→</u>	50% Stock S&P500 50% Bonds	70% Stock S&P500 30% Bonds	85% Stock S&P500 15% Bonds
Q1 2007	1.01%	0.87%	0.77%
YTD 2007 ending 3/31/07	1.01%	0.87%	0.77%
Since Inception			

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