



## INSTITUTIONAL INVESTMENT RESEARCH, LLC

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Newsletter Q3 2007, July 2, 2007

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#### Introduction and Contents:

Welcome back to the Alphareturns.com Newsletter published by Institutional Investment Research LLC. What a quarter Q2 2007 has been! Global stock markets staged a strong rally, sub-prime mortgage problems surfaced in the US, long term US Treasury rates increased, a number of high profile hedge funds fell on hard times, and the US real estate market continued to slide into further weakness. Meanwhile our model portfolios achieved extraordinary performance through it all! Looking forward, we will launch our Alphareturns.com website on Monday July 2<sup>nd</sup>. The website will give our subscribers more information on a daily basis and allow downloads of current and past newsletters. New clients are encouraged to download and read our Q1 2007 inaugural issue for a more in depth explanation of our investment philosophy and company mission.

Before we get into our Global Economic Overview and Model Portfolio Allocations for Q3, we would like to address a question from one of our subscribers about our use of ETF (exchange traded funds) instead of traditional mutual funds. In our model portfolios we tend to recommend the use of ETF's instead of mutual funds when possible because ETF's have the following advantages:

- ETF's generally have lower fee cost structures of 0.5% or less, where the average actively managed mutual fund's fee structure is 1.5% and the average index mutual fund fee structure is 0.83%. ETF's typically do not have high marketing and sales fees paid to brokers and financial advisors and therefore are not as likely to be pushed and churned into brokerage accounts by dis-honest advisors.
- ETF's are usually more tax efficient than mutual funds because the investor owns fractions of shares in the ETF that are bought and sold on an exchange. Therefore, the actions of other investors in the fund have a limited impact on tax liabilities incurred by the other investors in the ETF.
- ETF's have more market liquidity and transparency than mutual funds because the fractional shares of the ETF trade throughout the trading day instead of after the trading day has ended. Therefore, an ETF investor can always get an intraday quote on the current ETF value during the day instead of having to wait until an hour after trading ends as in the case of

mutual funds. Because of this structure, ETF's can also be purchased with limit orders, sold with stop loss orders, sold short, and even purchased with call and put options.

Hopefully this will help our readers better understand the superiority of ETF's when compared to traditional mutual funds. For more detail on the advantages of ETF's our readers can visit the ishares website URL: [www.ishares.com/learn/benefits\\_of\\_etfs/](http://www.ishares.com/learn/benefits_of_etfs/). One common complaint about ETF's is that their superior liquidity and trading flexibility may encourage investors to trade too frequently. While this may be true for undisciplined investors, we hope our readers will use discipline and only make changes in their portfolio each quarter when rebalancing or allocation changes are required. We receive no compensation from Ishares, Vanguard, Powershares, Barclays, or any other ETF provider. We simply believe that ETF's provide a superior investment vehicle for most asset class sectors.

Now for the rest of this issue where we will cover the Global Economy, our Model Portfolios, and each Model Portfolio's performance year to date:

### **Global Economic Overview and Outlook:**

The US economy continued to slow with sluggish GDP growth in the first quarter of 0.7%. Both residential and commercial real estate continued to weaken as leverage in both sectors showed signs of trouble on the low credit quality end of the spectrum. The OECD (Organization for Economic Co-operation and Development) is forecasting 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. So far, consumer spending and income growth have remained sufficient to maintain positive growth, but job reductions in the construction, auto, and mortgage sectors may weigh on the economy going forward. While US stock market valuations do not look to be 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. This weakness should keep the Federal Reserve on hold for the remainder of 2007 with regard to interest rates. We continue to tilt our portfolio stock weightings toward international stock sectors because of this potential US economic weakness. Having said that, we do see a pocket of unusual opportunity developing in the stock sector for large multi-national US companies. These US "large cap" stocks are now selling at low valuations that we have not seen in 20 years. Many of these companies have been steadily increasing earnings and book value over the past 5 years while their stock prices have been flat. Later we will discuss increasing the allocation for Large Cap US Value in our model portfolios to capture this opportunity. For the next year or so, it may look like we are abandoning one of our key investment principles regarding the historical superiority of small cap stocks when compared to large cap. It is true that our model portfolios currently do not contain a very high allocation to small cap stocks. However, we are currently in an unusual period where small cap stocks appear to be overvalued and large cap stocks are undervalued. This does not happen often, but since it is the case for now, we will have to go where the value is now and underweight small caps until they return to reasonable valuation levels.

While slow growth in the US will create headwinds for the global economy in 2007, growth in the Eurozone, Asian, and Latin American geographies 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. Even after impressive appreciation so far year to date, 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 of the S&P 500. In the Asia Pacific region we continue to favor the MSCI Australian stock index and the Asia ex-Japan index which are both up considerably year to date (21% and 17% respectively). Because of their run up we are recommending a slight reduction in these two allocations in order to “take some profit off the table” this quarter. As mentioned in the Q2 2007 newsletter, Australia completely paid off all of its national debt in 2007 and is enjoying 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 still 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 Chinese market is up over 89% so far in 2007 with an aggregate P/E of over 45. While some may think we are missing an opportunity in China, we can’t recommend an allocation to China when its valuation is so high. Stock market speculation in China and other emerging markets is driving this emerging market bubble to its inevitable conclusion.

### **Oil:**

As we have predicted all year, crude oil continues to price well north of \$60 closing at \$70.68 per barrel at the end of Q2. 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 continue to believe that the risks are tilted toward prices being higher and staying above \$60 per barrel during 2007. With regard to gasoline prices, our research continues to point to 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 over 89% 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. While the high price of gasoline, oil, and natural gas will continue to produce headwinds for the global economy, we do not believe high energy prices will push the global economy into recession.

### **US Dollar in Decline:**

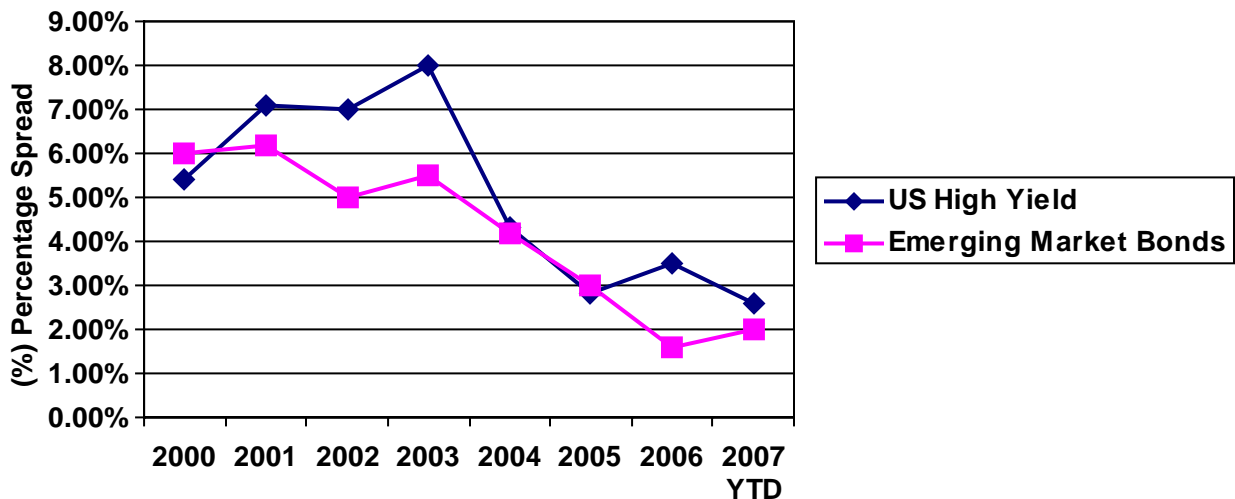
As discussed in our previous newsletters, the US Dollar continues to lose its value relative to other currencies with the US Dollar Index losing 2.15% year to date. Unfortunately gold fell and gave back some of the gains it had achieved in the first quarter. So far year to date, gold is up 1.7% after being up 4% at the end of the first quarter. With global inflation moderating (see section below on inflation outlook), our research is now pointing to a situation where gold mining companies may be a better investment than the bullion itself. Mining stock valuations are once again attractive and may yield higher returns going forward than the metals themselves. To better diversify this inflation protection commodity part of our model portfolios, we are recommending a switch from the symbol GLD gold bullion exchange traded fund (ETF) to the Metals and Mining exchange traded fund symbol XME. The XME fund tracks the Standard and Poor’s Metals and Mining index and is diversified into gold, steel, aluminum, coal, and uranium commodities.

### **Global Credit Bubble and Inflation Outlook:**

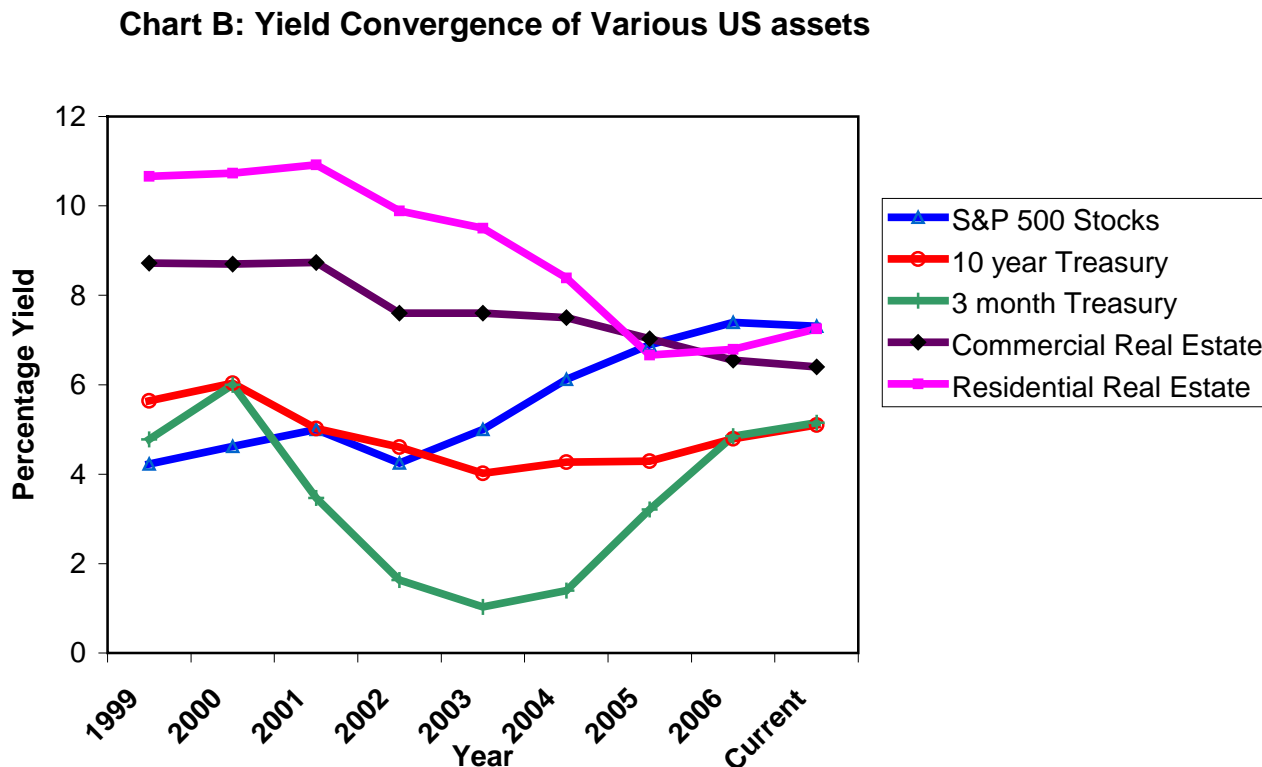
Perhaps the greatest immediate risk for the world's financial markets is the potential for the global credit bubble to burst. As we discussed in the Q2 newsletter, the lowest interest rates in a generation, liquidity created by derivatives, and deficit spending worldwide are causing a global bubble in credit and debt issuance. We have the lowest spread ever between high-risk junk debt and high-grade government debt (see Chart A below). For the first time in history, private equity firms are doing leveraged buyouts with loans that have little or no covenant protection for the lenders. Mortgage lenders have issued record levels of sub-prime mortgage loans that are now defaulting at record levels as well! Debt investors are taking on risk with little or no reward for credit quality or maturity as if there is no longer any risk in the debt market. Because of this, we continue to believe that credit spreads will widen back to historical norms causing a financial event in the credit market. 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 and bond markets. This is why we hold the highest quality "value style" stock sectors and short term US Treasuries in our model portfolios. In the event of a credit market financial crisis, our portfolios should be well positioned to weather the storm. If you have high yield bond funds in your current portfolio, you should be concerned. When the credit bubble unwinds and risk is re-priced to historical norms, high yield bond funds will lose much of their asset value. That is why we have no high yield/low credit quality fixed income in our model portfolios.

### **Chart A: Credit Spreads:**

**Credit Rate Spread to US Treasuries**  
**Source: Lehman Brothers**



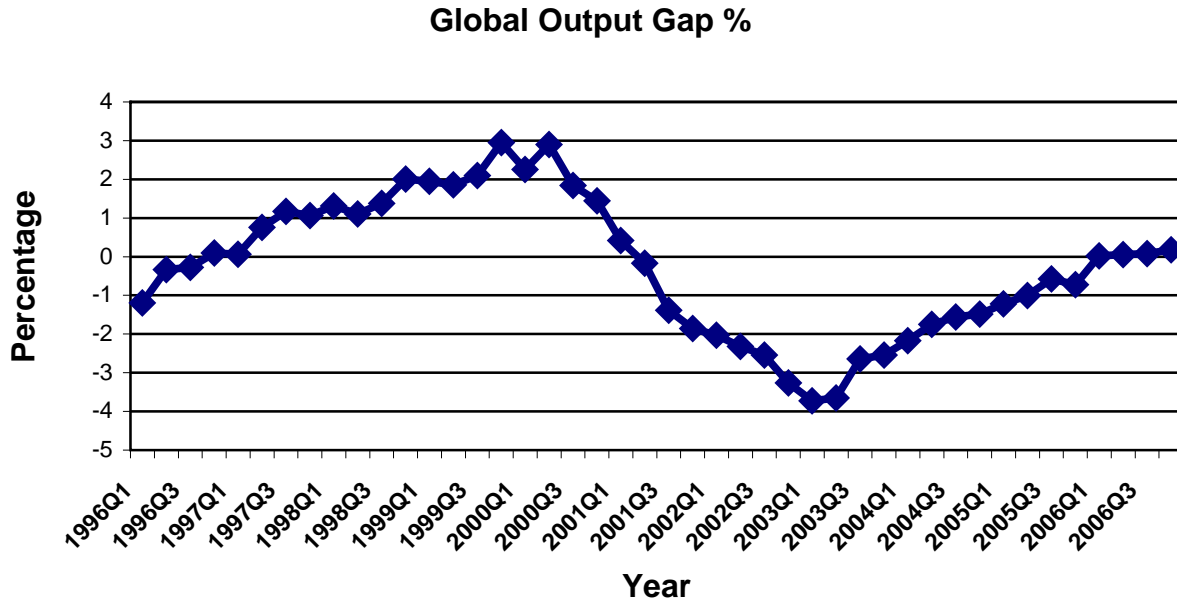
**Chart B: Yield Convergence of Various Assets – Has Risk Converged?:**



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

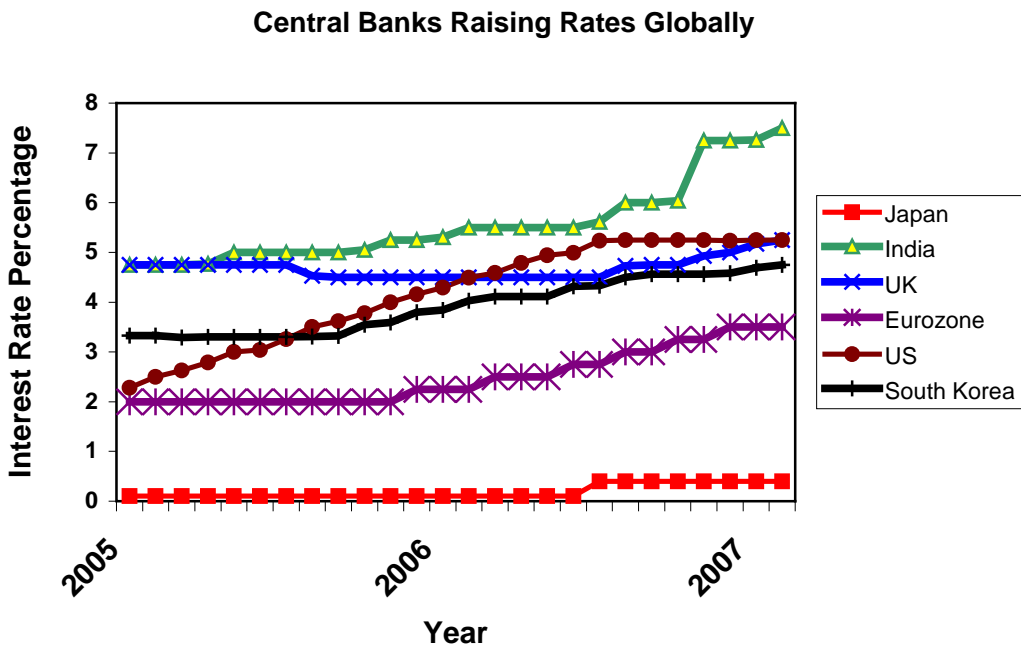
Regarding inflation, our research shows a closing of the global output gap (see Chart C below). The output gap measures the world’s productive output vs its potential capacity for production. This simply means that labor, capital, and equipment are running at potential capacity such that further growth is likely to lead to inflationary pressures. However, since the last newsletter we have modified our forecast for future inflation. We now believe that global inflation is moderating because central bank tightening (see chart D below) is having the desired result of holding inflationary pressures in check. If you look closely at the global output gap chart you will see that the gap is at 0% and leveling off. Global GDP growth has increased from 1.6% in 2002 to 3.1% now and is forecast to be 3.2% in 2008. Global money supply growth is leveling off and we have inflation in the world’s major economies comfortably below 3%: US= 2.7%, Eurozone= 1.9%, Australia 2.5%, Canada 2%, UK=2.5%, Japan=0%. Therefore inflation should stay calm unless we see an unexpected spike in global GDP growth and/or the output gap increasing above 1%.

**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 Bank Credit Tightening (Interest Rate Increases) = Calm 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:

**Metals and Mining Stocks:** While we still like gold as an investment commodity, we want to diversify into more commodity coverage including steel, aluminum, enriched uranium, copper, titanium, and other metals. The stocks of companies engaged in mining these metals are selling at attractive valuations that give investors a potentially higher return. 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 recommending the SPDR exchange traded fund (symbol XME) which tracks the S&P Metals and Mining index.

**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. This is a rather rare situation in the market and it may persist for another year or so. Therefore, we are temporarily departing from one of our key investment principles regarding the benefit of small and mid cap stock investing until these sectors become fairly valued again. Our model portfolios are now considerably underweight small and mid cap stocks and overweight large cap. Three exchange traded funds make up our US stock allocations: Vanguard Large Cap Value (symbol VTV), Vanguard Mid Cap Value (symbol VOE), and Vanguard Small Cap Value (symbol VBR).

**Foreign Value Stocks:** International Value stocks again look attractive from a valuation standpoint. These foreign value stocks will also gain from the falling dollar trend. European, Australian, and Asian ex-Japan (excluding Japan) stock markets look especially attractive due to lower price to earnings ratios and higher yields than US stocks. Europe, Asia, and Australia are also enjoying stronger GDP growth than the US this year. Their strong growth is forecasted to continue through 2008. We are invested in this sector with four exchange traded funds: Ishares MSCI EAFE Value Index (symbol EFV), Ishares S&P Europe 350 Index (symbol IEV), Ishares MSCI Australia Index (symbol EWA), and Ishares MSCI Pacific ex-Japan (symbol EPP).

**Foreign Small Cap 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 avoiding emerging markets. Valuations now look attractive for foreign small/mid cap dividend paying stocks in developed markets. Our allocation in this sector is fulfilled with the Wisdom Tree Investments (symbol DLS) foreign small cap dividend exchange traded fund.

**Fixed Income:** We believe that a re-pricing of risk in the credit markets will likely lead to a steeper yield curve. Therefore we are now recommending all of our fixed income to be allocated in Short Term 1 to 3 Year Duration US Treasuries. 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. The Ishares 1 to 3 year Treasury Bond exchange traded fund (symbol SHY) is our allocation vehicle for fixed income at this time. If your brokerage firm has a money market account yielding close to 5%, you may want to put your fixed income allocation into a money market account instead of the SHY exchange traded fund.

**Natural Resources:** This quarter we are re-entering the natural resources sector because we believe the falling US dollar, reasonable global GDP growth, 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 are now recommending a small allocation to the Ishares S&P GSSI Natural Resources Index exchange traded fund (symbol IGE).

**Alphareturns Model Portfolio Allocations For Q3 Calendar 2007:**

Symbol	Asset Class	Conservative Risk 1-3 year horizon	Moderate Risk 4-7 year horizon	Aggressive Risk 7+ year horizon
XME	Metals and Mining Stock ETF	5%	4%	3%
VTV	US Large Value Stock ETF	14%	19%	23%
VOE	US Mid-Cap Value Stock ETF	3%	4%	5%
VBR	US Small Cap Value Stock ETF	0%	3%	4%
EFV	International Value Stock ETF	12%	17%	22%
EPP	Asia Pacific ex-Japan Stock ETF	0%	4%	6%
DLS	Wisdom Tree Int'l Small Cap Dividend Stock ETF	3%	5%	7%
IEV	European Stock ETF	5%	6%	7%
EWA	Australian Stock ETF	3%	4%	5%
IGE	GCSI Natural Resources ETF	5%	4%	3%
SHY	1 to 3 year US Treasury ETF	50%	30%	15%

**Q2 2007 Performance Discussion:**

During the second quarter of 2007 our model portfolios once again outperformed their benchmarks (see table below). During Q207, our Conservative Portfolio returned 3.49% vs its benchmark of 2.83%, our Moderate Portfolio gained 4.57% vs its benchmark of 4.25%, and the Aggressive Portfolio gained 5.60% vs a benchmark gain of 5.32%. Once again this extraordinary performance was largely due to our allocations to international stocks and especially stocks in the Eurozone and Asia Pacific/Australia regions. US stocks did recover in May and June as expected. We are starting to see leadership in the US large cap sector represented by our VTV large cap value ETF. Gold was down 2.3% in the second quarter while our two fixed income bond ETF's were down a combined 2.28% for Q2 as US Treasury rates drifted upward.

Year to date, our portfolios are outperforming their respective benchmarks by an even wider margin. The Conservative Model Portfolio has returned 6.05% YTD vs its benchmark of 3.87%, the Moderate Model Portfolio has returned 7.50% YTD vs its benchmark of 5.16%, and the Aggressive Model Portfolio has returned 8.84% YTD vs its benchmark of 6.13% (see performance table below for details).

<u>Model Portfolios →</u>	<u>Conservative Risk (1 to 3 year horizon)</u>	<u>Moderate Risk (4 to 7 year horizon)</u>	<u>Aggressive Risk (7+ year horizon)</u>
Q1 2007	2.47%	2.80%	3.07%
Q2 2007	3.49%	4.57%	5.60%
YTD 2007 ending 6/29/07	6.05%	7.50%	8.84%
Since Inception 1/1/07	6.05%	7.50%	8.84%
<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%
YTD 2007 ending 6/29/07	3.87%	5.16%	6.13%

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

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