INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

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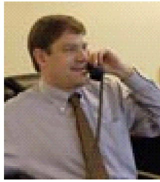

William A. Harris, CFA
Portfolio Manager

Welcome to Non-Normal Times

I'm not much for reminiscing, but it can be instructive. Here's how I wrapped up my first letter of 2006, when we were coasting along in a low-volatility market where stocks and bonds had been behaving themselves in a narrow, seemingly predictable valuation band:

Placid surfaces can conceal complex forces, and the relationships necessary to maintain so tight a trading range as we've enjoyed <into 2006> can vary far more in their extremity than appearances might suggest... But what happens in non-normal times, when events stray into what statisticians call the "tails" of the probability distribution, when the unlikely happens despite its unlikelihood? When complex systems break, they can break badly…

Engineering volatility out of the market for a time is not the same thing as engineering out risk.

If anything, 2007 proved to be a pivot point where risk roiled up anew, engineering failed and complex systems did indeed "break badly." In part, this was due to a broad overconfidence in statistical normality (plainly said, the expectation that life will abide by the "bell" curve). Markets are not, strictly speaking, normal; the bell curve underestimates the frequency with which extreme events tend to occur – in other words, the tails on either side of the curve are "fat." Just as the fabled 100-year flood can come a few times in a century, so will economic and financial events too often play out in ways wholly unexpected (indeed, even incalculable) by the elegant quantitative models on which staggering sums of money can be riding.

Indeed, 2007 marked the undoing of economic and financial structures, and of psychological structures as well. Too many investors on Wall Street and Main Street alike were extrapolating good times and very recent history, betting big (and too often unawares!) on a set of collective expectations, namely:

- U.S. housing prices in the aggregate never go down;
- The U.S. consumer is indefatigable, and constitutionally incapable of spending less;
- The ability to borrow is synonymous with liquidity;
- Problems that arise from existing debts can reliably be cured by taking on new debt; likewise from the lenders' perspective, bad credits can reliably be cured by extending new credit;
- Liquidity, whether flowing from our own Federal Reserve or the kindness of strangers abroad, will always be there to provide an exit should asset markets come under pressure;
- Market volatility, a relic of more barbarous times (read, pre-2004!), can be corralled and expunged via complex instruments;
- The credit rating processes we rely on in judging straight bonds work well when applied to structured and derivative instruments too;
- Complexity is our friend.

In 2007, these expectations either faced great duress or imploded altogether. And it was our long-held misgivings about many of them that enabled us on the whole to steer your portfolios to decent returns.

Total Return 2007	
Allen Trust Equities	11.63%
S&P 500	*5.49%*
Allen Trust Bonds	6.19%
Lehman Aggregate Bond	*6.96%*

Note: Time-weighted performance stated gross of fees.

Our outperformance in stocks was mainly attributable to two things, one relating to opportunism and the other to risk control. Pulling our returns higher (opportunism) were an overweight allocation to energy and target weight allocations to foreign markets. Just as important was a defensive decision to dramatically

underweight financial stocks (risk control), whose vulnerability to the forces of overvalued housing, leverage and complexity had concerned us for a while. By sidestepping much of the wreckage in banking, we were able to hold onto gains elsewhere. On the bond side we did well too: Though returns slightly lagged the index on a pre-tax basis, they improve significantly on an after-tax basis due to our considerable municipal bond holdings; moreover, our high quality holdings were less volatile, having a standard deviation nearly a quarter lower than the index's.

Here are some themes to look forward to in 2008:

- "Big bath" accounting: financial firms in particular will overload the next couple of quarters with bad news to cleanse their books and make way for dubious "improvement" in future periods; we will be wrong to read too much into the early bad news, and wrong to read too much into future "good" news;
- Fiscal stimulus packages from Washington DC will be suboptimal due to election-year posturing and pusillanimity;
- Issues of solvency will not be tractable to intervention measures based upon injections of liquidity;
- Rather than spurring increased consumption, stimulus efforts will increase savings; Americans will start repairing their household balance sheets (good in the long run, painful at first);
- Out of the fire, into the freezer: inflation gives way to deflation in the near term; initially, bonds benefit;
- The virtues of high quality municipal bonds in particular will again become manifest;
- Back into the fire: expectations of eventual dollar debasement will start steepening the middle to long end of the yield curve;
- International exposures will, for the first time in a long time, fail to live up to expectations; returns and diversification benefit will both disappoint (market correlations increase on the downside);
- The economy will continue to totter on a two-legged stool, held up by productivity and employment, but the latter will be tested;
- Conventional wisdom "buy the dips" will be supplanted by "sell the rallies;"
- As other investors' tolerance for taking on risk lessens, ours will grow (Buffett's maxim: "Be fearful when others are greedy, greedy when others are fearful");

And most importantly:

- We are going to survive… no matter what the markets bring or take… and no matter how badly the media try to scare you.

Now, having prognosticated a bit, I've got to tell you the limitations of all this. The list above constitutes not collective but selective expectations (my own), and they are largely tactical, or short-term, in nature. And I can't overemphasize: *expectation is not a strategy!!!* Whether or not I'm right on many of these items, surely I'll be wrong on some. The key is pursuing an approach robust enough to endure regardless of tactical expectations; Strategic Asset Allocation is ours. In the long run, discipline and self-knowledge, mine and yours both, will provide the mettle that matters.

Firm News

We kicked off the New Year with a new member on the investment team! **Monica Poveda** has joined us as **Assistant Portfolio Manager**. She performs investment research and analysis and assists in all aspects of managing client portfolios. An **MBA from the University of Oregon** with a BS, *magna cum laude*, from the University of Tulsa, Monica is **pursuing her Masters of Science in Financial Analysis (MSFA)** at Portland State's School of Business and is a **Level I candidate in the Chartered Financial Analyst (CFA) program**. Thank goodness she has such energy!