

INVESTMENT COMMENTARY

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The Markets

As the chart below shows, it was a good quarter for equity markets – domestic and international alike. What is not apparent is the increased volatility in the markets and the fact that June was generally negative for all domestic equity markets. Developed international equity markets were roughly flat in June, while Emerging International markets were quite strong during the final month – as they were during the first two months of the quarter.

Most bond markets were negative for the quarter, which puts them at low single digit returns for the first six months of 2007. Real Estate Investment Trusts (REITs) were down sharply for the quarter.

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	5.90	7.18	20.43	12.34	11.33	7.55
Russell 1000 Growth	6.86	8.13	19.04	8.70	9.28	4.39
Russell 1000 Value	4.93	6.23	21.87	15.93	13.31	9.87
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	5.30	9.90	20.83	17.16	16.39	11.86
Russell MidCap Growth	6.74	10.97	19.73	14.48	15.45	8.66
Russell MidCap Value	3.65	8.69	22.09	19.32	17.17	13.06
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	4.42	6.45	16.43	13.45	13.88	9.06
Russell 2000 Growth	6.69	9.33	16.83	11.76	13.08	5.28
Russell 2000 Value	2.30	3.80	16.05	15.02	14.62	12.14
<u>International Equity</u>						
MSCI World ex US	6.98	11.27	27.09	22.70	18.14	7.97
MSCI World ex US Growth	7.26	12.44	25.57	21.29	15.93	5.57
MSCI World ex US Value	6.69	10.11	28.56	24.07	20.32	10.14
MSCI Emerging Markets (Gross)	15.05	17.75	45.45	38.67	30.66	9.40
<u>Real Estate</u>						
Nareit Equity REITs	(9.04)	(5.90)	12.55	21.13	18.62	13.15
<u>Domestic Fixed Income</u>						
LB Aggregate	(0.52)	0.97	6.11	3.98	4.48	6.02

Domestic Equity Markets

Bigger was better during the second quarter, with the Russell 1000 (domestic large-cap equities) besting its smaller counterparts for the period. The R1000 returned 5.9% during the second quarter and is now up 7.18% for the first six months of the year.

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The domestic mid-cap markets almost matched the large-cap segment. The Russell Midcap Index returned 5.3% during the quarter, but clearly retains the performance lead for the year, up 9.90% on a year-to-date basis. The R2000 (domestic small-cap) brought up the rear returning 4.42% during the second quarter. The R2000 is also the laggard segment on a YTD and trailing twelve month basis, returning 6.45% and 16.43%, respectively.

Industry leadership was similar across market capitalization ranges with Energy, Information Technology, Telecommunications, Materials and Industrial industries all strong during the second quarter. Consumer sectors and interest rate sensitive groups like Financials and Utilities lagged.

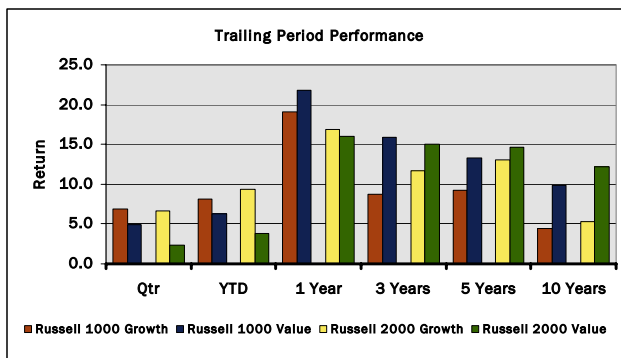
“Value” versus “Growth”

We reported last quarter that the labels “value” and “growth” can be somewhat confusing, as there is no industry accepted definition as to what makes one company a “value” company and another company a “growth” firm. Usually, a given index provider does have their own definition, but definitions are different across these providers. Add to this the fact that some companies exist in *both* value and growth indexes and a company may move around from group to group depending on the company’s characteristics at any given point in time.

A given economic scenario will favor certain industry groups over others. Likewise, certain industry groups are more prevalent on either the growth side of the market or the value side of the market. For example, Information Technology makes up 27% of the R1000 Growth Index, but only 3% of the R1000 Value Index. On the other hand, Financials make up only 8% of the R1000 Growth Index, but 34% of the R1000 Value Index. So, when the economic scenario is such that Financials do poorly, as was the case during the second quarter of 2007 when interest rates rose abruptly, one should expect the Financial sector to contribute negatively to the R1000 Value.

The second quarter was a period where sectors that dominate the growth side of the markets did quite well at the same time that those sectors on the value side fell short. The R1000 Growth Index returned 6.86% for the quarter while the R1000 Value Index returned 4.93%. If it had not been for the fact that Energy makes up a meaningful part of the value index and Energy performed so well during the period, the value index would have fared much worse.

The margin of out-performance by growth was even more evident in the smaller markets. The R2000 Growth (domestic small-cap growth) returned 6.69% for the period while the R2000 Value returned a more modest 2.3% during the quarter. It is worth noting that the majority of REITs reside in the R2000 Value index, dramatically lowering the quarterly return.



On top of an economic scenario that tends to favor many of the growth sectors, companies on the growth side were becoming more attractive simply from a valuation perspective. Despite growth’s performance in the second quarter, “Value” has trounced “growth” on a one-year, three-year, five-year and ten-year basis by wide margins (see chart).

International Equities – Developed Markets

Continuing their streak, developed international equity markets (as a whole), bested their US counterparts for another quarter. The US actually fared pretty well when considering returns in local currency terms. The US finished 8 out of 23 for the most recent three-month period. However, once you factor in the affect of the weaker US Dollar, the US rank is pushed down to 17 out of 23. The MSCI World Ex-US returned just under 7% for the second quarter.

It is sometimes interesting how we “slice and dice” the US stock market into many different pieces and then analyze and measure every little component part. Then, when we talk about the non-US markets (even if we limit it to developed markets), we view it as if it were one big unified financial entity. In reality, the sub-markets within the United States are quite similar. However, decomposing the developed international index that actually consists of 23 different countries shows a different picture. While we focus on an average quarterly return of 7%, the returns of the countries that make up the index ranged from 17.64% (Portugal) down to -0.64% (Japan) for the period.

International Equities – Emerging Markets

After a slow start to 2007 and seeing a one-day global sell off in February, emerging markets rallied in the second quarter with the MSCI Emerging Markets index returning roughly 15% for the period. The MSCI Emerging Markets index is now up 17.75% for the first six months. The winners during the first half of 2007 have been the markets in Brazil, Turkey, China, and Korea. The rally in the second quarter of 2007 is a result of the positive outlook on emerging markets steadily expanding economies, strong corporate earnings, and a declining US dollar.

Real Estate Markets

As noted earlier, REITs were largely negative for the quarter. The NAREIT Equity Index returned -9.04% for the quarter. International REITs fared slightly better, but were still negative. The S&P/Citigroup World ex-US Property Index returned -3.31% for the period. There are differing views on why these markets turned lower during recent months. One argument suggest that REITs (often purchased as a yield instrument) are interest rate sensitive and simply sold off as Treasury rates moved higher. Although this is theoretically possible, REITs have long since moved beyond being a simple “yield play”

A second theory suggests that investors simply associate REITs with the flailing housing market and the sub-prime mortgage debacle. While it is possible that fallout from a depressed housing market and growing problems in the mortgage market could spill over into other markets, REITs normally do not have much residential exposure. With this said, questionable mortgage loans were not necessarily limited to the residential sector. Make no mistake, aggressive lending practices also exist on the commercial side.

Finally, there is a widely held belief that REIT prices have simply gotten ahead of themselves. Investors continue to question values that are being assigned to underlying properties.

Domestic Fixed-Income Markets

Although the sell off in REITs was greater than that experienced with fixed-income securities, the bond market clearly affects a much larger investor group. The short answer to what

happened to the bond market is that interest rates moved higher and that is the one thing that bond markets do not like.

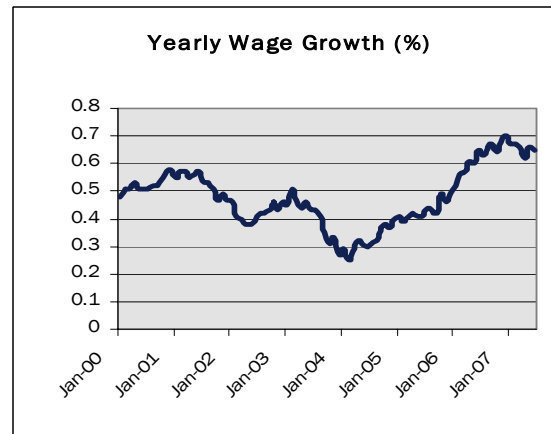
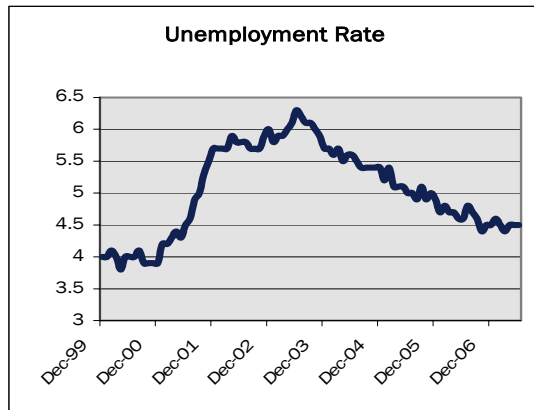
After returning 1.5% in the first quarter of 2007, the domestic fixed income market, as measured by the Lehman Brothers Aggregate Bond index, fell into negative territory in the second quarter returning -0.52%. Several factors can help explain the rising interest rates and the associated falling bond prices. First, data now suggests that perhaps our economy is a little more robust than was initially thought. Accordingly, bond investors who had loaded up on fixed-income in anticipation of a late-year rate cut by the Fed, began dumping these positions once the possibility of a cut all but disappeared. Fears also exist that certain governments like China may reduce their US Treasury positions in favor of higher yielding securities elsewhere.

Investors also took note of the risk – real and perceived – associated with certain debt instruments. Lower quality bonds sold off sharply towards the end of the quarter as investors associated the problems with the sub-prime mortgage debacle with other low credit instruments. Although still positive for the quarter, the high yield debt market was the biggest loser of the domestic fixed-income markets for the month of June.

The Economy

Despite the growing problems with the housing market and widely reported news concerning the sub-prime mortgage markets, the US economy rebounded nicely during the second quarter. Economic growth had sputtered along during the first quarter of this year at an annual rate of 0.7%. However, the economy kicked itself into high gear during the second quarter expanding at a rate of around 2.8%. While the US economy is not without its “potholes”, strong manufacturing activity, low unemployment, positive wage growth, a resilient consumer and corporate investment are collectively paving the way for at least modest economic growth. Most prognosticators feel that the US economy should grow at an annual rate of 2.5% to 3.0% over the next twelve months – below the long term average growth rate, but not below expectations set forth last year.

About those potholes – The American consumer has certainly done their part to perpetuate the economy and the financial markets. Because the consumer makes up 70% of GDP (gross domestic product) and is therefore a critical driver of our economy, we always need to focus on what might negatively influence the American spender. So far, the consumer has not been deterred by higher gasoline prices, higher energy prices, a downturn in the housing market or news of problems in the sub-prime mortgage arena. The American consumer can generally deal with a certain amount of bad news, especially when they are gainfully employed and they are seeing substantial investment returns.



Remember, the stock market has now been advancing for over four years. In fact, for the period from January of 2003 through the end of June, the S&P 500 has provided an average annual rate-of-return of 14.7%; the MSCI EAFE (developed international markets): 24.1%; the NAREIT Equity Index (Equity Real Estate Investment Trusts): 23.4%. These are huge returns and market participants have seen their investment portfolios skyrocket in value.

There is much being written about problems in the housing market and the even bigger problems in the sub-prime mortgage arena. So far, however, these problems have not affected the broader population – at least not to an extent such that buying habits have been affected. No doubt, the home building sector is feeling the pain. Likewise, peripheral industries like landscaping and home furnishings are being impacted. The inventory of existing homes for sale is also increasing and all of these factors have pushed home values slightly lower. However, modest fluctuations in home values do not impact (positively or negatively) most home owners unless they are contemplating a sale. Even if this is the case, “trading up” during a period of depressed home prices can be a good thing. It is true that mortgage rates have moved higher, but rates are still standing around 6.4%. These rates are not particularly high by historical standards.

You cannot pick up an investment related newspaper without reading about the problems in the sub-prime mortgage world. First, sub-prime mortgages are those mortgages that are made to homebuyers who do not have stellar credit. The real problem had more to do with the types of mortgages that were used in many of these transactions – adjustable rate mortgages and interest-only loans. Although there were ample warnings issued as to the risky nature of these instruments, certain greedy mortgage brokers used these instruments to entice homebuyers to purchase homes that were really just too expensive for them given their financial means.

As interest rates have moved higher, some of these buyers who were already on the edge, simply cannot meet their new higher payments. The result has been an increase in defaults. The decline in some home values has led to negative equity. Foreclosures in neighborhoods can exacerbate the declining home value issue and it all becomes a vicious cycle.

As bad as all of this sounds, the sub-prime mortgage market is still relatively small and directly impacts a fairly small number of homeowners. I do not want to trivialize this matter, as there are legitimate concerns as to the potential spillover effect of the sub-prime debacle. Remember, these mortgages were packaged and sold to the investing community. A few newsworthy buyers like two Bear Stearns hedge funds were almost bankrupted as a result of

holding large concentrated positions in these securities. Other problems are sure to surface and should interest rates continue to move higher, the problems could get worse.

In conclusion, the first two quarters have been good ones for the equity markets around the world. Continued economic strength and higher than expected corporate profits have boosted equities. The same factors have been a negative for the bond market, as it appears that interest rate cuts are further away than many anticipated. The decline in the housing market and sub-prime issues have the potential to wreak havoc in the markets, but so far, the damage has been localized to a few sectors and unfortunate investors. Our outlook for the equity markets for the remainder of the year remains positive, while the bond markets should experience mid single digit returns similar to the previous few years.

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