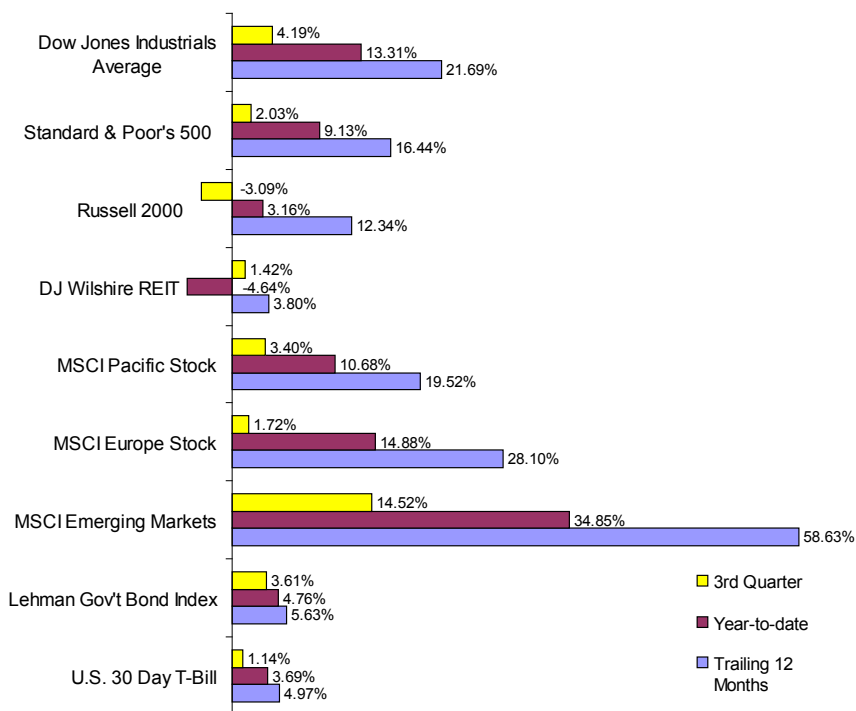


## WORLD MARKET SURVEY

In the first stage of an epic mood swing, equity markets plunged early in the third quarter. On the heels of a strong first half, investors suddenly realized that there was a fiasco brewing in the fixed income markets. Concerns centered around the sub-prime mortgage market. The refinancing boom made possible over the last 10 years by historically low real interest rates and increasing home values meant that borrowers could afford much greater leverage, without increases to their monthly debt service. The Adjustable Rate Mortgage (ARM), aggressively marketed over the last few years, made it even easier. With ARMs, the borrower takes the risk of rising market rates – a risk that banks retain on fixed rate notes. Thus the interest rate at issue of an ARM is lower than on a comparable fixed rate note, but once the initial rate guarantee period has lapsed, the rate on the note, and the monthly debt service, fluctuates with the market.

(continued on page 8)

**Index Returns: Third Quarter 2007, Year-to-Date, & Trailing 12 Months**



## ETFs: A CRITICAL REVIEW OF A POPULAR NEW INVESTMENT PRODUCT

At Schultz Collins Lawson Chambers, Inc. [SCLC] we firmly believe in the benefits of diversification, both within and between asset classes.

Prudently managed portfolios optimize their risk/return posture when company (security level) risk has been thoroughly diversified, and asset class risk is mitigated by including multiple asset classes with low correlation to each other. While some investment products offer both security and asset class diversification, we generally prefer to construct portfolios from a series of funds, with each fund representing a different asset class.

Relative to a single fund solution, this approach permits us to customize the portfolio's asset allocation to our client's unique objectives, to use funds from different management firms, and, for taxable portfolios, to introduce strategic tax management

techniques. Generally, we like to use passive (indexed) funds for portfolio construction, because they offer broad security level diversification, consistent asset class exposure, low costs, and tax efficiency.

Exchange Traded Funds [ETFs] were first introduced almost fifteen years ago. They are pooled investment vehicles that usually track indexes. As such, they share many characteristics with traditional indexed mutual funds. Casual observers (and ETF sales officers) might presume that SCLC would regularly advocate the use of ETFs for portfolio construction, tax management, and investment cost control. However, although we have recommended ETFs for client portfolios for over ten years, and increase our use of ETFs every year, traditional mutual funds continue to represent the core of most client portfolios. This is partially explained by our firm's inherent conservatism (we like to think of it as prudence) with respect to any new

investment idea. But many of our concerns about ETFs pertain to technical issues with how many ETFs are organized, managed, and traded. In this article, we'll share with you how ETFs work, when they are effective, and when they should be avoided.

### INDEX MUTUAL FUNDS VS. ETFs

#### Open-End Mutual Funds

Most investors are familiar with traditional open-end mutual funds. "Open-end" means that the fund's number of shares varies daily—when investors send in cash to purchase the fund, new shares are created, when investors sell the fund, shares are redeemed and cease to exist. The first open-end index fund offered for retail sale was the Vanguard 500 Index Fund, introduced in 1976, which tracks the investment performance of the S&P 500 stock index.

## ETFs: A CRITICAL REVIEW

***Under the 1940 Act, mutual fund shareholders receive various investor protections such as threshold diversification requirements, standards of governance, information disclosure, and so forth.***

Mutual funds are governed by and registered under the Investment Company Act of 1940. Technically, mutual funds are corporations, managed by an independent board of directors elected by fund shareholders. Under the 1940 Act, mutual fund shareholders receive various investor protections such as threshold diversification requirements, standards of governance, information disclosure, and so forth.

Investors acquire shares of open-end mutual funds by sending the fund a check or wire in exchange for new fund shares. Shares are bought from or sold to the fund at the fund's net asset value (NAV), which is calculated at the end of market trading each day. The fund thus stands as the counterparty to each financial transaction—issuing new shares to investors who wish to buy, and sending cash to investors who wish to sell their fund shares. Since the fund itself always serves as the investor's counterparty, open-end mutual funds do not trade on a stock exchange.

The open-end mutual fund structure requires the fund to employ:

- (1) A sub transfer agent to keep track of individual shareholder positions for a variety of informational, accounting and payment purposes;
- (2) Investor assistance personnel to field inquiries regarding investment opportunities or administrative procedures; and,
- (3) Governing boards of directors to oversee a variety of activities, including negotiating contract terms with the fund's investment advisor.

### Closed-End Mutual Funds

Closed-end mutual funds are generally similar to open-end funds. They are investment companies and are registered under the 1940 Act. However, shares of closed end funds are traded differently from open-end funds. A fixed number of shares of a closed-end fund are made available through an initial public offering [IPO]. Shares are then listed for trading on a public exchange. Shares may trade at a premium or discount to the fund's NAV, depending on supply and demand for the fund. Most closed end funds typically trade at a discount to NAV.

### Exchange Traded Funds

Shares of Exchange Traded Funds also represent ownership of a pooled investment fund. However, as their name suggests, the shares are traded between individual investors (or, more often, between individuals and market specialists) rather than between the investor and the fund. The first ETF, Standard & Poor's Depository Receipts, (SPDR) was developed by the American Stock Exchange (AMEX) in 1993. The original SPDR has become enormously successful, and today represents the largest trading volume of any single security on the AMEX.

One benefit of trading on an organized exchange is that buy and sell transactions can occur at any time during trading hours. Furthermore, an unanticipated benefit of the ETF trading protocol is the elimination of temptations to allow select investors to take unfair advantage of "stale" end of the day prices. As you may recall, several large mutual funds were caught in trading scandals because they permitted hedge fund managers to submit and execute orders after market close. The mutual fund scandals form the subject matter for several *Investment Quarterly* issues. Following investigations by the SEC and several state Attorneys General, some funds had to pay substantial fines, settlements and investor restitution.

In addition to the differences in trading venues and trade order conventions, the most significant difference between a traditional open-end mutual fund and an ETF lies in the share creation mechanism. A traditional mutual fund collects money from the investor, and issues fund shares to the investor. The fund's investment manager can choose to use the investor's cash to purchase securities, but there is no direct linkage between cash inflows and security purchases.

The ETF share creation structure has two "layers." In the first layer, an "authorized participant" exchanges a basket of securities with the ETF fund sponsor. An organization receiving permission to launch an ETF by the SEC under the 1940 Act is typically a division of a major bank such as State Street or Barclays. The authorized participant (specialists, market makers and other institutional investors) receives ETF shares, which, in turn, can be traded by the public. Thus, the ETF itself never participates directly in the stock market. The authorized participant may buy and sell securities to create baskets that mirror the index which the ETF tracks. The only way the authorized participant can obtain ETF shares is by exchanging the stock baskets for ETF shares directly with the fund. This transfer mechanism can convey extraordinary tax advantages to individual investors.

In the second layer, individual investors place orders for these shares (and pay a stock-like commission) at their brokerage firm; the broker submits the order to the market for execution. Interestingly all ETF shares are registered to The Depository Trust Company (DTC). However, ETFs cannot be purchased directly from either the DTC or the ETF fund sponsor; rather, they must be purchased through a brokerage firm. Thus all shareholder accounting is done by the brokerage. This structure means that ETF expense ratios are generally lower (in some cases, dramatically lower) than those of comparable index mutual funds, because ETFs have no need to track shareholder ownership, tax basis, and other investor-specific information. Likewise, they do not need to support a retail investor investment assistance staff because the fund has direct dealings only with an authorized participant.

***The only way the authorized participant can obtain ETF shares is by exchanging the stock baskets for ETF shares directly with the fund. This transfer mechanism can convey extraordinary tax advantages to individual investors.***

## ETFs: A CRITICAL REVIEW

### LEGAL STRUCTURES AND INVESTOR PROTECTIONS

SCLC prefers ETFs that are organized as investment companies (i.e., that are governed by and regulated under the 1940 Act). However, there are several legal organizational structures for index ETFs:

**Exchange-traded open-end index funds.** All things equal, SCLC prefers this legal structure. The fund is organized as an open-end mutual fund and is registered under the 1940 Act and generally incorporates broad flexibility for index construction, security lending, and dividend reinvestment. iShares ETFs, produced and marketed by Barclays Global Investors (BGI) are well-known examples of this type of ETF.

**Exchange-traded closed end index funds.** This type of fund is organized as a closed-end mutual fund. Like their open-end counterparts, the ETF is an investment company and is registered under the 1940 Act. The total number of shares of the ETF is generally fixed. The portfolio asset value is generally based on the investment performance of the initial amount of assets under management. Trading these ETFs is generally similar to trading closed-end mutual funds.

Bond funds are often organized as closed-end ETFs. The closed-end fixed-income ETF series produced and marketed by Nuveen Investments is a well-known example of this type of ETF.

SCLC does not often recommend this type of investment vehicle. Two issues concern us:

- (1) Although the number of shares is fixed, closed-end funds often raise additional capital by issuing “rights” offerings. These offerings convey the right to purchase newly issued shares to existing shareholders (often at a favorable, pre-determined price). If an existing investor is unwilling or unable to take advantage of a rights offering by purchasing more shares of the fund, the investor suffers a dilution of ownership. We generally avoid investments that may directly or indirectly require investors to make additional incremental purchases.
- (2) Closed-end funds often introduce leverage by issuing two share classes: Preferred and Common. Preferred shares pay short-term interest rates, and promise investors a “preferred claim” on fund assets. Proceeds from Preferred stock sales are used to purchase long-term investments for the remaining investors. Common shareholders may earn extra income because of the spread between the lower rates paid to Preferred shareholders and the earnings from longer term investments. However, the per-share value for Common stockholders is considerably more volatile because all

increases or decreases in portfolio value are attributed to the common shares. *Caveat Emptor* – unsophisticated investors may be blindsided by a yield-oriented marketing campaign, only to find that ETF share value is dropping faster than Enron stock.

**Exchange-traded Unit Investment Trusts (UITs).** These ETFs are also registered under the 1940 Act, but they are not organized as investment companies. SCLC rarely recommends these types of ETFs because they have less asset management flexibility. Less flexibility may not be a problem for ETFs tracking larger, more liquid indexes, but the inability to use index sampling techniques or a stratified cell optimization management approach can be highly detrimental when tracking an index of smaller capitalization stocks. Examples of exchange-traded UITs include the original S&P 500 SPDR, the DIAMONDS series that track certain Dow Jones indices, and the QQQ (‘Qubes’) ETF that tracks the NASDAQ 100.

Historically, UITs had difficulty reinvesting dividends, but currently some brokerage houses now support automatic dividend reinvestment programs. SCLC notes that major discount brokerages (TD Ameritrade, Fidelity and Schwab) currently permit automatic reinvestment for most ETFs, including UITs.

**Exchange-traded Grantor Trusts.** These ETFs are not registered under the 1940 Act and have severe limitations on management flexibility. In some circumstances, this type of fund may not be able to maintain adequate diversification. Consequently, SCLC generally recommends avoiding these ETFs. An example of Grantor Trust ETFs is the HOLDR series produced and marketed by Merrill Lynch.

Finally, investors should be aware that certain ETF sponsors are aggressively marketing products that look and feel much like ETFs, but which, in reality, are very different. These investments are Exchange Traded Notes [ETNs]. ETNs promise returns that track fixed income and commodity indexes. However, the future value of the ETN depends solely on the fund sponsor’s promise that the note will track the performance of the index, because they are unsecured debt obligations rather than direct ownership of an asset pool. Given the legal status of these investments, SCLC does not currently recommend their use.

#### Investment Costs and Asset Management

There is a vast quantity of marketing articles debating whether ETFs are more or less costly than index mutual funds. Not surprisingly, the answer is, “it depends.” The few credible academic studies suggest that the cost analysis is a function of several variables, some of which are stochastic (i.e., random). Among the important variables are brokerage costs (commissions, bid/ask spreads etc.), amount and frequency of purchases and sales, planning horizon, investor tax

***Caveat Emptor - unsophisticated investors may be blindsided by a yield-oriented marketing campaign, only to find that ETF share value is dropping faster than Enron stock.***

***There is a vast quantity of marketing articles debating whether ETFs are more or less costly than index mutual funds. Not surprisingly, the answer is, “it depends.”***

## ETFs: A CRITICAL REVIEW

rates, and current and future tax law.

However, there are some rules of thumb that are generally accurate for several common situations:

- If you trade frequently, or dollar cost average small sums into a portfolio, the costs of ETF trading will be much higher than trading a comparable no-load index fund (unless you are paying a fee to trade the index fund). A 401(k) plan participant making regular contributions would generally want to avoid using ETFs if a comparable no-load index fund were offered through the plan.
- The larger the investment into an ETF, the shorter the breakeven period (where breakeven is calculated as the point in time where the total costs of acquiring and owning the ETF [with a low ongoing expense ratio] equals the total costs of acquiring and owning the equivalent index mutual fund [with a higher ongoing expense ratio]). However, this rule may break down at larger purchase levels, because many no-load index funds have reduced minimum purchase requirements for institutional share classes, or have introduced new, lower cost share classes for moderately large purchases (typically, with a minimum between \$100,000 and \$250,000).
- As a general rule, taxable investors, anticipating long-term holding periods, should prefer ETFs to mutual funds because of their unique tax advantages. This general rule, however, is sometimes bitterly contested with respect to specific funds. Vanguard, for example, asserts that several of its index mutual funds have large loss carry-forwards which should assure a high degree of tax efficiency for years to come. Marketers of tax-managed mutual funds assert that they are equal or superior to ETFs when the analysis factors in the tax bite taken out of the investment.
- If you are a tax-favored investor (e.g., IRA or company-sponsored retirement plan) that plans to hold an investment position for the long term, you can be relatively indifferent between owning an ETF or an index mutual fund. That is to say, factors other than acquisition and ownership costs (index benchmarks, fund tracking efficiency, share liquidity and so forth) are more important.

SCLC reviews a wide array of investment products to fund the asset class exposures targeted in each client's written Investment Policy Statement. Critical judgment is required to select appropriate investment configurations to fit the needs of different investors for tax management, income (wealth accumulation vs. retirement decumulation), intergenerational growth,

liquidity, cost control, etc. A single client portfolio might include multiple owners (IRAs, Living Trusts, Personal accounts, etc.), with multiple beneficiaries (current and future generations), using investment vehicles with differing structures and characteristics (e.g., mutual funds distributing realized gains annually). Different owners and beneficiaries would experience different current and future tax liabilities, depending on what investments are purchased through each account. As the overall portfolio is periodically rebalanced to maintain its preferred risk control structure, tax liabilities may be generated. Finally, remember that mitigating unnecessary costs (including taxes) is a critical element of long-term financial success. Managing multiple multifaceted and frequently conflicting objectives is a complex problem that can only be solved through simulation analysis.

### TAX MANAGEMENT: OPPORTUNITIES AND PITFALLS

For taxable investors, ETFs hold out the promise of significant tax benefits. The benefits generally segregate into two categories:

#### No "Phantom" Capital Gains Distributions

Unlike traditional mutual funds, ETFs do not distribute realized capital gains incurred due to investor share redemptions to ongoing shareholders. Although investors in both ETFs and mutual funds must receive a pass-through of realized capital gains generated from portfolio activities, such as purchases and sales of stocks entering or leaving the underlying index, corporate mergers, acquisitions, and spin-offs, the gains realized and distributed for these reasons are usually very small. However, open-end mutual funds also usually create or redeem shares through taxable events: an investor sends cash to a fund or receives cash back from a fund. As we discussed, ETF shares are created through a process involving in-kind tax-free exchanges between the fund and the authorized participant. The individual investor is isolated from the tax consequences of such share creations and redemptions. Individual investors in mutual funds regularly receive gains distributions because other shareholders left the fund. Conversely, individual investors in an ETF are not affected by the actions of other shareholders. The embedded but unrecognized capital appreciation in your ETF share value remains untaxed until you sell. Several commentators note that the provision in the current estate tax law allowing for a death-time step up in tax basis for personally-owned investments could permit an individual ETF investor to escape capital gains taxes through several generations, assuming that the shares are not sold (and, of course, assuming that the tax break remains in place).

#### Enhanced Opportunities to Recognize Tax Losses

The proliferation of sector ETFs allows taxable investors to magnify the opportunity to harvest short-term investment losses for tax purposes. Sector ETFs

*As a general rule, taxable investors, anticipating long-term holding periods, should prefer ETFs to mutual funds because of their unique tax advantages.*

## ETFs: A CRITICAL REVIEW

decompose the S&P 500 into nine sectors that mirror the nine industry group classifications established by Standard & Poor's. Most S&P sector ETFs (State Street's Select Sector SPDRs, Vanguard's recently renamed VIPERs, and Barclays' Dow Jones iShares) are organized as open-end funds. Separating the single S&P investment into nine components can increase opportunities to realize losses, because:

- (1) Individual sectors are more volatile than the aggregate index; and,
- (2) Sectors do not move in lockstep with the aggregate index.

The concept of tax loss harvesting is straightforward: if an investment's current fair market value is below its tax basis, it can be sold to "book" a loss on the investor's tax return. These losses have economic value and can enhance the effort to accumulate wealth. But tax loss harvesting is complicated.

Factoring in both trading costs and expense ratios, investing in sector ETFs is significantly more costly than investing in an ETF that tracks the S&P 500 index. Although an aggregation of the nine sector ETFs should, in theory, equal the S&P 500 index portfolio, construction of sector ETF portfolios may be distorted by several factors. These include the imposition of selection committee decisions on which sector stocks to include, or the diversification requirements of the 1940 Act, which may force some sector positions to be under or over weighted relative to the broader index. In actual practice, the sector fund portfolios of various ETF products can differ significantly. The State Street Bank Select Sector SPDR series, for example, are actually sector funds that are selected by a Merrill Lynch committee. The fund's prospectus states (p. 37):

*"S&P does not guarantee the accuracy and/or completeness of the S&P 500, the Select Sector Indexes or any data included therein. S&P makes no warranty, express or implied, as to results to be obtained by Merrill Lynch ..."*

### The "Wash Sale" Rule

Perhaps the thorniest obstacle to negotiate, however, is IRC §1091, commonly known as the Wash Sale Rule:

*"In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired ... or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed under section 165 ..."*

The most troublesome aspect of §1091 is the fact that the IRS has not defined the term "substantially identical stock or securities" with respect to ETFs and index mutual funds. Most commentators suggest that the sale of a mutual fund and purchase of an ETF is a transaction involving investments that are not substantially identical. However, there is no universal agreement on this point. Since some ETFs are organized as a different share class of an underlying mutual fund, it may be particularly risky to attempt tax loss harvesting through ETF/mutual fund transactions by selling one share class and buying another within a single fund family. Other issues lurk to thwart the unwary. A particularly nasty tax loss harvest trap occurs in portfolios electing automatic dividend reinvestment. The IRS considers such reinvestment an acquisition of the fund, which, if the dividend is paid within 30 days of the sale of the shares it bought, might invalidate the legitimacy of the tax loss.

SCLC believes that owners of taxable portfolios considering systematic tax loss harvesting should make an informed decision regarding:

- (1) The extra trading expenses required for rebalancing to the target asset allocations (e.g., nine trades for sector SPDRs versus one trade for an S&P 500 ETF);
- (2) The advisability of an automatic dividend reinvestment plan (at least for fixed income funds) versus the extra trading costs required for manually reinvesting dividends;
- (3) The extra tracking risk vis-à-vis the benchmark index created by parking the dividends in cash accounts; and,
- (4) The uncertainty regarding the Revenue Service's ultimate position on wash sale rules.

SCLC believes that tax-loss harvesting can be valuable for taxable investors. However, this portfolio management strategy requires not only care and skill, but a degree of conservatism in light of the current lack of IRS guidance.

### SUMMARY

Although they are relatively new financial instruments, ETFs represent a useful alternative to traditional indexed mutual funds. ETFs may have cost advantages, and are potentially more tax-efficient, than their open-end brethren. Furthermore, ETFs introduce opportunities for sophisticated tax management strategies. However, ETFs can be offered under a variety of legal structures, offering differing levels of investor protection. Some ETFs may incur significantly greater risk than their mutual fund counterparts. When used prudently, ETFs can be a useful tool for achieving investment objectives. But before committing a significant portion of a portfolio to ETFs, investors should be sure they fully understand the unique characteristics of the ETFs they are purchasing.

***The concept of tax loss harvesting is straightforward: if an investment's current fair market value is below its tax basis, it can be sold to "book" a loss on the investor's tax return.***

***Perhaps the thorniest obstacle to negotiate, however, is IRC §1091, commonly known as the Wash Sale Rule.***

## ACTIVITIES AND ARTICLES

**With the demise of the traditional pension plan, employer sponsored 401(k) plans now function as the most important retirement savings vehicle for millions of Americans.**

**What does it mean to be a fiduciary, and how do the Prudent Investor Standards play out in today's complicated and unforgiving financial markets?**

SCLC's primary business is to provide investment counsel to private and institutional clients. In the process, we spend considerable resources on developing and publishing our intellectual capital. We also seek to maintain an active presence in the consulting community, where issues of national importance are debated and resolved.

### **Jon Chambers - Testimony and Advocacy on 401(k) Fees**

In July, a joint meeting of the Western Pension & Benefits Conference and the American Society of Pension Professionals & Actuaries was held in San Francisco. The Western Benefits Conference attracted hundreds of consultants and practitioners from around the country to discuss a broad range of issues concerning the nation's private pension and retirement plan system. Officials from the U.S. Department of the Treasury and the U.S. Department of Labor were present to provide updates and clarifications on recently enacted and pending legislation. SCLC's Jon Chambers was the Co-Chair of the Program Committee for this event.

With the demise of the traditional pension plan, employer sponsored 401(k) plans now function as the most important retirement savings vehicle for millions of Americans. An emerging topic at the Western Benefits Conference centered on the disclosure of fees and expenses that apply to individual accounts in 401(k) plans. There is a growing realization among regulators and legislators that, because of the complicated, often opaque structure of 401(k) plans, it is difficult or impossible for the plan sponsor (i.e., the employer) and the plan participant (the employee) to know exactly what expenses are being charged to plan assets, and whether they are reasonable. Since fees and expenses reduce return, these costs can have a profound impact on the employees' financial security in retirement.

Jon Chambers is a nationally recognized expert on 401(k) plan fees. In early October, Jon presented written and oral testimony before the Education and Labor Committee of the U.S. House of Representatives on a proposed 401(k) fee disclosure bill (the 401(k) Fair Disclosure for Retirement Security Act of 2007). The testimony is available at [www.schultzcollins.com](http://www.schultzcollins.com). The Government Accountability Office (GAO) recently met with Jon in our San Francisco office to obtain his assistance in preparing their report to Congress on the fee disclosure issue. Jon was also called to Washington, D.C. to meet with the SEC to describe current 401(k) industry disclosure practices. Officials at the Department of Labor have also debriefed him on the topic. Jon's expertise in evaluating 401(k) Plan fee arrangements is a direct benefit to our clients.

### **Patrick Collins - Journal Articles on Prudent Investing**

A fundamental aspect of SCLC's advice to clients is our adherence to the Prudent Investor Standards. In this regard we fully acknowledge our role as a fiduciary. But what does it mean to be a fiduciary, and how do the Prudent Investor Standards play out in today's complicated and unforgiving financial markets? Patrick Collins has devoted much of his career to studying and writing about this topic. He is adjunct professor at the University of San Francisco, where he teaches a course in Portfolio Management in the Masters of Science program for executive MBA and Financial Analyst degree candidates. Patrick enjoys a winter break in Bangkok, where he is an instructor for a similar program affiliated with USF.

Patrick recently published a number of articles:

"Life-Cycle Funds and Retirement Savings Elections," *Retirement Counseling Society of Financial Service Professionals* (June, 2006).

"Prudence," *The Banking Law Journal* (January, 2007).

"What Trustees Should Know about Asset Management Approaches and Rebalancing Elections," *Wealth Strategies Journal* (forthcoming) (with Josh Stampfli).

"Without More: Trust Investment Manager Selection and Retention Policy," *The Banking Law Journal* (forthcoming).

"Evidencing Care, Skill and Caution in The Management of ILITs," *ACTEC Journal* (Fall, 2006), pp. 162-175 (with Kathryn A. Ballsun & Dieter Jurkat).

In addition to publishing articles in various journals, Patrick Collins and other SCLC principals write a variety of position and research papers, and provide the content for SCLC's *Investment Quarterly*. During the past year we have added a series of working papers to our web site that discuss Commodities, Value Investing, Portfolio Rebalancing Options and Approaches, and Investment Performance Evaluation. We were pleased to note that the newly published and revised edition of *The American Law Institute's Restatement of the Law Trusts* (Vol. 3: The Prudent Investor Rule) contains eight citations to publications written by members of SCLC. A selection of our articles and publications can be found at [www.schultzcollins.com](http://www.schultzcollins.com).

**SURVEY OF INDICES & FUND AVERAGES**  
PERIOD AND ANNUALIZED COMPOUND RETURNS IN PERCENT

	Third Quarter 2007	12 Months Ending 09/30/07	3 Years Ending 09/30/07	5 Years Ending 09/30/07	10 Years Ending 09/30/07
<b>Inflation Index &amp; Risk Free Rate</b>					
Consumer Price Index	-0.02	2.49	3.07	2.82	2.57
U.S. 3-Month Treasury Bills	1.19	5.01	3.97	2.83	3.65
<b>U.S. Stock Market (Large Companies)</b>					
Standard & Poor's (S&P) 500 Index	2.03	16.44	13.14	15.45	6.57
S&P/Citigroup Large Cap Growth Index	3.77	16.78	10.36	12.93	4.76
S&P/Citigroup Large Cap Value Index	0.39	16.11	15.97	18.04	7.67
Avg. Large Cap Blend Fund ‡	1.65	16.48	13.10	14.72	6.29
<b>U.S. Stock Market (Small Companies)</b>					
Russell 2000 Index	-3.09	12.34	13.36	18.75	7.22
Dimensional US Micro Cap Fund	-4.03	11.55	13.20	20.40	10.57
Russell 2000 Growth Index	0.02	18.94	14.10	18.70	3.65
Russell 2000 Value Index	-6.26	6.09	12.51	18.70	10.07
Avg. Small Cap Blend Fund ‡	-3.67	13.61	13.54	18.18	8.71
<b>Real Estate</b>					
DJ Wilshire REIT Index	1.42	3.80	19.63	21.88	12.80
<b>Fixed Income (Bond) Markets</b>					
Lehman Government Bond Index	3.61	5.63	3.79	3.49	5.88
Avg. Intermediate Gov't Bond Fund ‡	2.59	4.31	3.10	2.88	4.92
Lehman Municipal Bond Index	1.83	3.10	3.86	4.02	5.32
Avg. California Intermed/Short Muni Bond ‡	1.41	2.33	2.73	2.52	4.10
Credit Suisse High Yield Bond Index	0.05	8.36	7.48	12.49	6.38
Avg. High Yield Bond ‡	-0.08	7.08	6.71	11.24	4.30
Citigroup World Gov't Bond Index	7.21	8.70	4.61	6.98	5.93
Average World Bond Fund ‡	4.57	7.47	4.86	7.05	5.40
<b>International Stocks</b>					
MSCI EAFE Foreign Stock Index	2.18	24.87	23.24	23.55	7.97
Average Foreign Large Blend Stock Fund ‡	3.31	26.18	23.06	22.08	7.29
MSCI Europe Stock Index	1.69	27.51	24.72	25.46	9.61
MSCI Pacific Stock Index	3.30	19.17	20.08	19.36	4.89
MSCI Emerging Mkt Index (excl. dividends)	13.70	54.84	37.44	35.26	9.15
Average Emerging Markets Fund ‡	11.79	55.48	38.59	36.33	11.40

‡ Source: Morningstar Principia 09/30/2007

## WORLD MARKET SURVEY

(continued from page 1)

Fearing that continued strong economic growth since 2003 would prompt inflation, the Fed had been gradually tightening the money supply since 2004, and retail rates eventually began to rise. Some ARM borrowers found themselves unable to pay, and banks found themselves liquidating repossessed real estate in the teeth of a major correction in that market. Investors who had bought securitized mortgages from underwriting banks saw the creditworthiness of their Collateralized Mortgage Obligations slashed. Fears of a vicious cycle triggered a rush to U.S. Treasuries and a sharp drop in world stock markets.

On August 17, the Fed reversed course, lowering the discount rate at which it lends to commercial banks. A month later, the Fed cut its target short-term interest rate. The fear and doomsaying that permeated markets during the first half of the quarter suddenly shifted to guarded optimism, equity markets leapt upward, and by the end of September, stocks had approached or exceeded record levels. The S&P 500 ended the quarter up 2.03%, the Dow Jones Industrials advanced 4.19% and the NASDAQ Composite gained 3.77%. Not all stocks were treated equally during the quarter's gyrations. While large cap glamour stocks rebounded, small stocks languished: the Russell 2000 Index was

off 3.09% for the period.

The fallout from the mortgage debacle was not limited to the U.S. Stocks in the developed markets were generally down for the quarter. Measured in local currency, the MSCI Europe Index fell 2.72%, and the MSCI Pacific Index was off 3.44%. At the same time, the U.S. dollar was hitting record lows against the Euro and other key currencies, which pushed foreign stock returns in the opposite direction for U.S. investors. Adjusted for the dollar effect, the Europe Index ended up 1.72% and the Pacific Index gained 3.40%, the latter enjoying nearly a 7% swing due to currency adjustments. Of course, the developed foreign markets are hardly the only story in international stocks. Recent reports indicate that China will be the largest contributor to global GDP this year, and China's nascent stock market was up 39.9% for the quarter.

In the bond market, the benchmark 10-year Treasury Note ended the quarter with a yield of 4.58%, somewhat lower than the 5.34% yield at the end of the second quarter. The credit squeeze has supported demand for Treasury Notes and Bonds, helping to moderate the yield. In the commercial real estate market, Real Estate Investment Trusts (REIT's) recovered somewhat from the deep slide earlier in the year. The Wilshire REIT Index ended the quarter up 1.42%.

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### Individual Country Returns Third Quarter 2007

	US Dollar	Local Currency
<b>North America</b>		
United States	1.0%	1.0%
Canada	8.4	1.2
<b>Latin America</b>		
Argentina	-11.2	-9.5
Brazil	17.3	12.0
Chile	-1.8	-4.7
Mexico	-4.0	-2.8
<b>Africa</b>		
South Africa	3.4	1.1
<b>Europe</b>		
Austria	-8.2	-12.8
Belgium	-0.5	-5.5
Denmark	7.5	2.3
Finland	16.4	10.6
France	-0.8	-5.8
Germany	3.1	-2.1
Great Britain	-1.2	-2.7
Ireland	-10.9	-15.4
Italy	-0.4	-5.4
Netherlands	2.1	-3.1
Norway	5.9	-2.8
Portugal	-7.8	-12.5
Spain	3.2	-2.0
Sweden	0.9	-4.8
Switzerland	1.6	-3.2
<b>Asia</b>		
Australia	9.3	4.8
Hong Kong	22.9	22.1
Indonesia	8.8	10.1
Japan	-1.9	-8.7
New Zealand	-5.8	-3.7
Philippines	-3.1	-5.7
Singapore	5.3	2.2
South Korea	14.2	13.2
Taiwan	5.9	5.2
Thailand	11.0	10.2

Source: Dow Jones Global Indexes