



Registered Investment Advisor

Mob 310.808.8080

Fax 815.572.0566

www.lgadvisors.com

Mid Quarter Client Newsletter (Q2 – 2007)

Q2 / 2007 High-Level Market Update

During Q2, the U.S. economy showed conflicting signs of health. On the one hand, weakness was evident in the anemic 1.3% GDP growth rate and in the declining inflation rate. On the other hand, strength was seen in the job market with unemployment dropping to an extremely low level of 4.5%. Additionally, corporate profits in the U.S. increased by a strong 7 – 8%. Globally, it was clear that economic conditions remained favorable, with GDP continuing upwards in Europe and Emerging Markets. In China, GDP grew 11.1%, almost ten times the percentage gain in the U.S.

Most major stock markets continued to hit new highs, despite the mixed economic news out of the U.S. Part of this continued surge upwards was due to the return of the retail investor, courted by daily news headlines of new highs in popular indexes. However, the mass entrance of retail investors can often be the sign of a temporary top in the markets. Continuing with the China example from above, retail investors are undergoing a market-mania of similar proportions to what we saw here in the U.S. with the NASDAQ bubble in 2000. College students are investing their tuitions, homeowners are investing with proceeds from home equity loans, and even conservative retirees are parting with their savings to participate in the speculative nature of the market. All of this enthusiasm has driven China's market to a P/E (price-to-earnings) multiple approaching 50. This measure means that investors are now paying \$50 for every \$1 of earnings, which is the equivalent of receiving a 2% interest rate on your investment while assuming all the risks associated with having your money in the stock market. In comparison, the long-term average P/E ratio for China is closer to 12. China's high GDP growth rate may justify a premium above the historical P/E ratio, but current valuations are through the roof, and indicate the potential for a 75% correction to historical norms. China is one of the most overvalued markets in the world, but its continual rise illustrates the level of excessive euphoria evident across many popular global stock markets.

LotusGroup indicators continue to suggest a reasonable chance for a correction in the near-to-mid-term future. We expect a healthy 8 – 10% price correction to better align prices with underlying valuations. Thereafter, we expect a resumption of the current uptrend based on the continued globalization trend. Consequently, client portfolios have been repositioned into a more defensive bias with higher cash, bond, and precious metals exposure. Additionally, we have replaced riskier equity markets with better valued equity markets (e.g. we substituted Taiwanese holdings in place of Chinese holdings, choosing a market with a P/E ratio of 14 over one with a P/E ratio of 50). Clients will continue to participate in the ongoing rally, albeit with a smaller percentage of high-risk assets, potentially resulting in a smaller gain relative to our benchmarks if the markets continue to move somewhat irrationally upward. As indicated in previous newsletters, we prefer to protect our client's long-term assets when the probabilities aren't sufficiently in our favor, even if that creates the potential for short-term underperformance relative to our benchmarks. Over the long term, the market will recognize valuation differences, punishing the overvalued and rewarding the undervalued.

Financial Markets on the Global Stage – How “Free” are U.S. Markets?

For most of recent history, Wall Street has dominated when it comes to most things financial: Stock Listings, Initial Public Offerings (IPO's), Mergers & Acquisitions, etc. This almost monopolistic situation was driven by an extremely open regulatory environment, the proximity of most major international banks, an attractive environment for talented multinationals / immigrants, and access to a wealthy investor base in the U.S. public. For both domestic and foreign companies, listing their company on any one of the U.S. exchanges (NYSE, NASDAQ, and AMEX) was a no-brainer. Until recently, more IPO's came through the U.S. exchanges than all others combined!

Since 9/11 and the Enron scandal, the scales have been tipping drastically away from the U.S., driven by its increased barriers to entry coupled with massive deregulation around the globe. In the U.S., the relatively new Sarbanes Oxley Act (SARBOX) has created a large burden of time and cost to small and mid-sized companies who wish to go public on a U.S. exchange. For foreign firms wanting to list in the U.S., difficulties stretch beyond SARBOX. Foreign firms have to deal with such issues as limited work visas for their management teams (quotas are typically filled within hours of their once annual listing), hostile treatment of their international workers upon arrival at U.S. airports, and limited tax advantages for their resident workers. In many respects, these regulations and limitations, originally intended to protect the individual U.S. investor and citizen, have caused domestic and foreign companies to either remain private or seek alternative exchanges to list their shares overseas. Conversely, global markets such as London and Dubai have massively deregulated their exchanges, reduced taxes, and accentuated their geographical positioning relative to their neighboring European and growing Middle Eastern markets.

As evidence of the growing shift, record numbers of U.S. companies converted from being public to private during 2006, and the London Stock Exchange completed 419 IPO's versus only 174 in the U.S. Tallying up all the numbers, U.S. exchanges have gone from a 60% market share of IPO's to under a 7% market share in recent years. So why is this bad? When companies are private, the retail investor has limited access to investing in these companies, with access coming mainly through private equity or hedge funds that are only open to accredited investors (individuals with a net worth in excess of \$2 Million). When they go overseas, not only do U.S. investors miss out on investing in these growing new firms, but U.S.-based banks and exchanges lose the fees associated with taking a company public, and the U.S. government loses the associated tax revenues as well.

What will it take to turn this situation back in favor of the U.S.? While it would be difficult to once again achieve a 60% market share, the U.S. can significantly improve our competitive position by pursuing reduced regulation and lower taxation on investment capital. Fortunately, leaders such as NYC Mayor Michael Bloomberg and U.S. Treasury Secretary Hank Paulson have been leading efforts at easing SARBOX restrictions, increasing work-visa quotas, and reducing the tax burden on investment capital. We will need these ideas to succeed if we are to remain competitive in global financial services. Furthermore, it is as important as ever look outside of just the U.S. markets as an investor, diversifying into other global markets and asset categories as is done in each LotusGroup portfolio. It is difficult to determine whether or not the U.S. will improve its competitiveness, but through diversification, we can spread our risk and participate in the growth of other competing markets.

As always, we remain committed to helping you achieve life's dreams!

Warm Regards,

LotusGroup Advisors, LLC.