

# MARKET UPDATE



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### Why "lotus"?

*The lotus is a symbol of purity in many ancient cultures as its beautiful flower grows from swamp water.*

*Making wise investment decisions—from planning and executing a strategy to adapting to change—can be a lot like wading through swamp waters at times.*

*Our mission is to grow and protect your wealth, so like the lotus, it may bloom to its full potential.*

## Q2-2007 MARKET RECAP

Q2/07 ushered in a divergence of returns across asset classes. On the positive side, our US stock market benchmark (S&P 500) joined advancing international and emerging market equities with a strong 5.8% return, showing particular strength in the first two months of the quarter.

While global economic growth continued unabated, the advancing US stock market seemed to ignore slower domestic growth (GDP in the US slowed to a 0.7% crawl in Q1/07 compared to global growth of nearly 5%), rising interest rates, and the continued housing slump. Instead, bullish investors bet on a quick housing market resolution, improving domestic growth forecast for future quarters, and the re-emergence of the retail investor given recent headlines of new stock market highs.

Conversely, bonds staged a pullback, with our US bond market benchmark (Lehman US Aggregate Bond) down by -0.93%. While the stock market turned a blind eye to apparent risks, the bond market was far more cautious about rising interest rates and the continued sub-prime mortgage crisis in the United States. Along with bonds, other interest-rate-sensitive asset classes declined as well. Real estate investments continued to decline due to higher borrowing costs, while gold and precious metals declined against a strengthening US dollar.

This divergence in returns would insinuate that the stock market is too bullish, the bond market is too bearish, or both. Consequently, we believe that the stock market will undergo a short-term correction to the tune of 7-10%, the bond market will rebound upward 4-7% from current levels, or we will witness a mix of both until they are back in balance. We discuss this divergence, and the potential opportunity for investment gain it provides, on the next page.

6/30/2007 Major Indices Update	Q1 2007	Q2 2007	YTD 2007	1-Year (June 30, 2007)
S&P 500 (total return)	0.64%	6.28%	6.96%	20.59%
NASDAQ (price change)	0.26%	7.50%	7.78%	19.85%
Dow Jones (price change)	-0.87%	9.11%	8.76%	23.04%
Russell 2000 (total return)	1.95%	4.42%	6.45%	16.43%

Recent US market performance.

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## PORTFOLIO REVIEW & COMMENTARY

Given the nature of our diversified portfolios, LGA clients benefited from advancing equity markets while being dragged down by interest-rate sensitive investments. Returns were also muted by our temporarily heavier than normal cash positions that generated a conservative, albeit lower-than-benchmark return.

we have been more defensive with our client portfolios and have held the aforementioned higher cash position. This doesn't mean that the market won't still move upward as

*"It is important to remove the emotions of greed and fear"*

To explain our higher than normal cash position, we look at reward to risk ratios. We typically seek out a 3:1 reward to risk ratio in our investments, where we can potentially earn \$3 for every \$1 we risk. This approach allows us to have a margin of safety in our investments. However, many asset classes are currently at a 1:1 ratio where each \$1 of potential gain requires a \$1 risk. Given the low ratio value,

it did in Q2. It only means that we believe the risks for generating that gain are mounting and we would prefer to be more defensive until prices correct to more appropriate levels. We continue to participate in the rally, but our lower equity positions and higher cash positions have dragged on short-term returns.

In using a diversified and active approach such as

LGA's, significant deviations from the benchmark average can occur during short-term time periods when asset classes move in different directions. Portfolios benefit when the stock market benchmark is down and our alternative assets move upward. Conversely, portfolios will drag when the stock market is up and our alternative assets move downward (as was the case in Q2). Understanding these short-term dynamics, it is important to remove the emotions of greed and fear, to understand short-term risks in an overheating market, and to capitalize on long-term opportunities afforded by divergences in the market when they revert back to the norm. While we occasionally have to live with a short-term underperformance, our non-emotional approach creates an opportunity for longer term benchmark-beating returns, combined with lower draw-downs relative to buy-and-hold strategies.

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As always, we are available to discuss any questions you may have regarding our progress towards your investment and financial objectives.

Please call or email us to schedule a time to review.

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## COMPANY UPDATES

In keeping with our goal of continuous improvement, we added two new investments to client portfolios during Q2/2007:

### Commodities – Agriculture and Foreign Exchange

Both of these investments offer similar long-term returns as equities, but are not correlated to global markets. Therefore, a benefit of adding these investments will be increased long-term returns through rebalancing when asset classes diverge.

Additionally, these new investments will continue to reduce the volatility of LGA client portfolios, reducing draw-downs during market declines. LGA now draws upon 34 different asset classes to build and manage client portfolios. As of end Q2/07, 21 of these 34 asset classes were incorporated into client portfolios, selected for their reward-to-risk potential and their diversification benefits for each client's specific risk profile.

Your LotusGroup Team,



Andy Seth and Raphael Martorello  
 Client Management and Investment Strategy