Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON **NICK LEVINSON, CFP®**

MAY 2007 COMMENTS

PERSONAL HIGHLIGHT:
Vic's mother (Nick's grandmother) reaches age 100 on July 3rd

THE CURRENT STOCK MARKET RISE, AND YOUR ASSET ALLOCATION:
At the end of July 2006, the S&P 500 index stood at 1,277. Ten months later, at the end of May 2007, this index closed at 1,531. This gain of 20% has brought the S&P 500 index to an all-time high, surpassing the previous high reached over seven years ago (and retracing the almost 50% decline that occurred during the bear market of 2000-02). For additional context, over the 18 months prior to July 2006, this same S&P 500 index had gained less than 10%. Since efforts are constantly made in the popular media to explain these price movements after the fact, we think it important to reiterate basic principles:

1) These gains may or may not continue; the future, as always, is unpredictable. (Reference Nick Taleb's new book, "The Black Swan", for much more on this subject. We will be discussing the ideas in this book extensively in future Comments);
2) Whatever appropriate asset allocation you had last summer, assuming your goals and your risk tolerance have not changed significantly, remains appropriate now, subject to the idea of rebalancing (see below);
3) Rebalancing refers to the idea of selling some of the higher-performing asset class, to return the allocation to its prior, appropriate percentage mix. If you have additional funds to invest, rebalancing can also occur by buying more of the lower-performing asset class. In either case, rebalancing is the opposite of buying into the higher-performing asset class as it moves higher and higher.

LONG-TERM CARE INSURANCE (LTCI):
For those of you who do not have LTCI, we suggest you review this subject with us. We believe LTCI is an important part of planning for the conservation of accumulated assets, and deserves your attention.

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COMMENTS: INDEX RESULTS for period ending MAY 2007

STOCKS	YEAR 1999	YEARS 2000-02	YEARS 2003-05	YEAR 2006	YTD 2007	MAY 2007
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	9.3%	3.9%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	7.9%	3.4%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	9.3%	4.9%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	9.0%	3.9%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	9.3%	4.5%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	7.8%	3.3%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	13.1%	4.7%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	11.0%	4.7%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	11.3%	3.4%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	12.9%	6.4%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	3.2%	(0.2)%
BONDS						
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	1.2%	(0.7)%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	0.5%	(0.5)%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	1.8%	(0.1)%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	1.4%	0.3%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	4.1%	0.6%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	1.9%	(1.3)%

NOTE: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of the first year the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
		1999				**2000**				**2001**		
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3
BONDS	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0
Interm. Tax.												
		2002				**2003**				**2004**		
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9
BONDS	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0
Interm. Tax.												
		2005				**2006**				**2007**		
S&P 500	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2%			
NASDAQ	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3%			
BONDS	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4%			
Interm. Tax.												

MAY 2007 COMMENTS

STOCK index prices during May posted strong gains for the second consecutive month, following a first quarter of virtually no gain. The May gains for the three major US indexes (Dow Industrials, S&P 500 and NASDAQ) ranged from 3.3% to 4.5%, and YTD gains ranged from 7.8% to 9.3%. See the third paragraph below on this page for additional discussion, and see page 2 above for all figures for the month, YTD, and since 1999.

BOND returns (price change plus interest) declined, as prices fell along with a sharp rise in market interest rates. The benchmark 10-year US Treasury yield closed at 4.91%, which was 28 bps higher than April’s close, and is now closer to the 12-month high of 5.25% than the November 2006 low of 4.47%. The current short-term overnight rate set by the Federal Reserve remained at 5.25%. Even with this month’s rise in rates, short-term yields remain higher than longer-term yields (“inverted yield curve”). This situation has persisted for almost a full year, and is highly unusual, since the normal relationship of 10-year yields to short-term yields is positive 200 bps, not negative (34) bps. As time passes, it is likely that either longer-term rates will rise, or shorter-term rates will decline. Bond returns for the month, YTD, and since 1999 are set out on page 2 above.

ECONOMIC NEWS for the month, particularly the most recent news, pointed to stronger growth ahead, after a weak first quarter. One day after the Q1 GDP growth figure was announced at a mere 0.6%, the monthly employment figures came in higher than expected. Further, the slow growth in Q1 was cited as a reason why stronger growth is expected going forward (WSJ, 6/1/07, A2, and 6/2-3/07, A3). Corporate profits (WSJ, 6/4/07, C1), and durable goods orders (WSJ, 5/25/07, A6), were also strong. Home prices and sales continued soft, however (WSJ, 5/25, and 5/26-27/07). Overall, there were enough positives in the month’s economic news to provide some fundamental support for the rising stock prices and rising interest rates, since stronger economic growth tends to move market interest rates higher, as investors become concerned (rightly or wrongly) that the Federal Reserve will raise rates in order to contain inflation.

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From a longer-term standpoint, the stock market rally that began decisively in March 2003 now exceeds four years. But the declines of the preceding three years (2000-02) have resulted in price changes (since the highs of 2000), excluding dividends, far below their long term historical averages, with the Dow Jones up 16%, the S&P 500 even, and the NASDAQ down a stunning (48)%. In a fascinating observation, the mutual fund company Vanguard notes that from 1926 through 2005, in only six of 80 years did stock prices fall within 2%, up or down, of the long-term annual average return of plus 10.4%.

Since the spectacular 1994-99 bull market began, all three major indexes have remarkably similar average annual returns (ranging from 10.2% to 10.7%) that are almost identical to the 10.4% average annual return of the stock market dating back to 1926. As these returns converge, the idea of "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), comes clearly into focus. But Vanguard's observation is also meaningful, since annual returns during the bull market were far higher than the long-term averages, and the returns from 2000-YTD 2007 were far lower.

The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, even with (so far), a fairly stable very-long-term average return. Key Questions: Your relevant time frame and tolerance for risk.

	S&P 500 (1)		DOW (1)		NASDAQ (1)	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
Year End 2004	1,212	(21)%	10,783	(8)%	2,175	(57)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year End 2006	1,418	(7)%	12,463	+6%	2,415	(52)%
Year-to-date 2007	1,531	+0.3%	13,628	+16%	2,605	(48)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999

	S&P 500 (1)	DOW (1)	NASDAQ (1)
End 1994	459	3,834	752
End 1999	1,470	11,500	4,070
Gain	1,011	7,666	3,318
Avg.Ann.%Gain:'95-'99; 5 years	26.2%	24.6%	40.2%
MAY 2007	1,531	13,628	2,605
Gain	1,072	9,794	1,853
Avg.Ann.%Gain:'95-4/07; 12.42 yrs	10.2%	10.7 %	10.5 %

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's fees.

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INVESTMENT CONCEPTS

We have been quoting David Swensen's book, "Unconventional Success", in many of our Monthly Comments. Swensen, the highly successful manager of Yale's endowment fund, advocates that individual investors use low-cost, market-mimicking index funds to implement their asset allocations. To add further support to the idea that broad-based index funds are the best solution to the question of what to use in implementing your asset allocation, we now have the newest book by John Bogle ("Little Book of Common Sense Investing", copyright 2007, John Wiley, Publisher). Bogle, who is widely credited with inventing the index fund and who ran Vanguard for many years, has written this book in a simple, highly readable (although somewhat redundant) style.

In fact, for anyone who spends any time considering what investments to use in constructing their portfolios, this book should be required reading, since the time investment is quite modest. Rather than spending hours trying to pick market-beating investments, take far less time to read the book and in turn you will never need to waste any additional time in what Bogle has demonstrated to be the futile effort to beat the markets. The remainder of this section is a summary of each chapter as presented in the book.

Introduction: "Simple arithmetic suggests, and history confirms, that the winning strategy is to own all of the nation's publicly-held businesses at very low cost. By doing so you are guaranteed to capture almost the entire return that they generate in the form of dividends and earnings growth. The best way to implement this strategy is by buying a fund that holds this market portfolio, and holding it forever… in an index fund… designed to mimic the overall performance of any financial market or market sector….The funds that represent the entire stock market…eliminate the risk of individual stocks, of market sectors, and of manager selection, with only stock market risk remaining" (p. XI).

Bogle advocates the use of "the classic index fund, broadly diversified, holding all or almost all of the $15 trillion capitalization of the US stock market, operating with minimal expenses and without advisory fees, with tiny portfolio turnover, and high tax efficiency, buying an interest in each stock in the stock market in proportion to its market capitalization and then holding it forever" (p. XIII).

Bogle distinguishes between investing, a "winner's game", and trying to beat the stock market, a "loser's game." "Over the past century our corporations have earned a return on their capital of 9.5 % per year (before adjusting for inflation). Therefore investing in these businesses is a winner's game….But the typical investor's return has probably lagged the market's return by at least 20%....The relentless rules of humble arithmetic define the game. As investors, all of us as a group earn the market's return….Each extra return that one of us earns means that another of our fellow investors suffers a return shortfall of precisely the same dimension. Before the deduction of the costs of investing, beating the stock market is a zero sum game….After the deduction of the costs of investing, beating the stock market is a loser's game" (pp. XIII-XV).

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"Most investors in stocks think they can avoid the pitfalls of investing by due diligence and knowledge, trading stocks with alacrity to stay one step ahead of the game. But while the investors who trade the least have a fighting chance of capturing the market's return, those who trade the most are doomed to failure….Mutual fund investors…pick funds based on the recent performance superiority of fund managers, or even their long-term superiority, and hire advisors to help them do the same thing….Oblivious of the toll taken by costs, fund investors willingly pay heavy sales loads and incur excessive fund fees and expenses, and are unknowingly subjected to the substantial but hidden transaction costs incurred by funds as a result of their hyperactive portfolio turnover….Contrarily, for those who invest and then drop out of the game and never pay a single unnecessary cost, the odds in favor of success are awesome….They own the businesses that earn substantial returns on their capital and pay out dividends….In the aggregate these businesses grow with the long term growth of our vibrant economy….Buying and holding the entire stock market is simple, the arithmetic on which it is based is irrefutable, but it is not easy to follow its discipline" (p. XVIII).

Chapter Three discusses the various broad-based indexes (first the S&P 500, then the Total US stock market index), and quotes Swensen, chief investment officer of Yale's endowment: "A miniscule 4% of funds produce market-beating, after-tax results with a scant 0.6% annual margin of gain. The 96% of funds that fail to meet or beat the Vanguard S&P 500 index fund lose by a wealth destroying margin of 4.8% annually (p. 33). (OUR NOTE: No time period was provided with this particular quote).

Chapter Four reviews "the relentless rules of humble arithmetic" that form the basis for "why investors as a group fail to earn the returns that our corporations generate through their dividends and earnings growth, ultimately reflected in the prices of their stocks. To understand why they do not, we need only recognize the simple mathematics of investing: All investors as a group must necessarily earn precisely the market return, but only before the costs of investing are deducted. After subtracting the costs of financial intermediation, all those management fees, brokerage commissions, sales loads, advertising costs, and operating costs, the returns of investors must, and will, and do fall short of the market returns by an amount equal to the aggregate amount of those costs" (pp. 35-36).

In addition to all the costs reported as the expense ratio, there is "a giant additional cost…the hidden cost of portfolio turnover, estimated at a full 1% per year, …consisting of "brokerage commissions, bid-ask spreads, and market impact costs" (p. 37).

"By and large, fund managers are smart, well-educated, experienced, knowledgeable and honest. But they are competing with each other. When one buys a stock, another sells it. There is no net gain to fund shareholders as a group. In fact, they incur a loss equal to the transaction costs they pay" (p. 40).

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Chapter Five discusses how even the disappointing reported returns from mutual funds aren't the returns actually earned by fund investors. "Fund returns do not tell us what return was earned by the average fund investor, which turns out to be far lower….We need to consider dollar-weighted returns, which account for the impact of capital flows from investors, into and out of the fund….Money flows into most funds after good performance is achieved, and goes out when bad performance follows….Actual average fund investors earned not 10%, but 7.3% (the index fund investor also earned less, at 10.8% compared to the 12.3% for the fund itself)" (pp. 50-51) Bogle states that "counterproductive market timing and fund selection" are the causes for this performance lag. "As the bull market of the 1990s neared its peak, people poured too much of their savings into equity funds. Further, they paid a selection penalty, pouring their money into the market not only at the wrong time but into the wrong funds" (p. 53).

Bogle reports that for the full 10-year period from 1996-2005, aggressive funds had an average 7.8% annual return, compared to 9.1% for the index fund, but the actual investor return was MINUS 0.4% (p. 57). Investors piled in near the highs, and then sold out near the bottom, missing much of the recovery. "Fund investors have been chasing past performance since time eternal…but the fund industry has played on these emotions, bringing out new funds to meet the fads and fashions of the day….The winning formula for success in investing is to own the entire stock market through an index fund, and then do nothing" (p. 58). (Bogle also quotes Charles Schwab and Mark Hulbert, who tracks fund and newsletter performance, as favoring index funds (p. 59)).

Bogle cites five possible ways to deal with this problem, covered in the next five chapters:

1) Select winning funds based on their long-term records;
2) Select winning funds based on their recent short-term performance;
3) Get professional advice in selecting funds likely to outpace the market;
4) Select funds with low costs, minimal turnover, and no sales loads; and
5) Select a low-cost index fund that holds the stock market portfolio.

Chapter Eight considers "selecting long-term winners." The main problem: "Easy as it is to identify past winners, there is little evidence that such performance persists in the future" (p. 79). Bogle starts with 355 equity funds with a record dating back to 1970, through 2005. Of these funds, only 9, or 1 in 39, outpaced the market by more than 2% per year, and "six of those nine winners achieved their superiority many years ago, often when they were of small size…" (pp. 81-82).

Chapter Nine discusses "selecting short-term winners." Bogle analyzes the top performing funds during the period 1997-9, and what happened to them in the bear market of 2000-02. These funds earned 13% for the full six years, well below the S&P 500's cumulative gain of 30%, but the key point was that "investing after seeing returns that averaged almost 280% in a soaring bull market, nearly all the buyers missed the upside… and caught the full force of the downside….While the funds earned the 13%, the investors in those funds lost 57%" (pp. 92-93). Bogle also shows that the pattern of top performing funds in one time period becoming average performers in a subsequent period exists in more sedate markets as well (pp. 93-95).

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Chapter Ten considers "seeking advice to select funds." Bogle makes this key (for us) distinction: "I am focusing (in this chapter) only on the ability of advisers to help you select equity funds that can produce superior returns for your portfolio. Professional investment advisers provide many other services, including asset allocation, information on tax considerations, and advice on how to save while you work and on how to spend when you retire; and they are always there to consult with you about the financial markets…. Experienced advisers can also help you avoid the potholes along the investment highway (…to help avoid making the dumb mistakes of chasing past performance and trying to time the market). At their best these important services can enhance the implementation of your investment program" (p. 101). (Thank you, John Bogle!)

Now to the question of whether advisers can help pick market beating funds. "It's hard for me (Bogle) to imagine that as a group they are other than, well, average. That is, their advice on equity fund selection produces returns for their clients that are probably not measurably different from those of the average fund….If they select funds with the lowest all-in costs they will do better for you, and if they avoid high turnover funds that are highly tax inefficient, they will pick up savings in transaction costs and taxes. And if they put those two strategies together and emphasize low cost index funds, as many advisors do, so much the better for their clients"(102-03). (Thank you again!)

Bogle also quotes William Bernstein, author of "The Four Pillars of Investment Wisdom": "Your adviser should use index/passive stock funds wherever possible. If he tells you that he can to find managers who can beat the indexes, he is fooling both you and himself" (p. 112).

Chapter Eleven considers "focusing on the lowest cost funds." "Performance comes and goes…costs go on forever." Such costs include the fund's expense ratio, and the charges paid when shares are purchased and sold (p. 114). "Costs account for most of the difference in the annual net returns earned by the funds" (p. 116) "If you are seeking the lowest cost funds, why limit the search to actively managed funds? The classic index fund had the lowest costs of all, an expense ratio averaging 0.2% per year" (p. 118).

Chapter Twelve discusses "holding index funds that own the entire stock market." These funds have the lowest expense ratios, and turnover costs of zero (p. 122) "In the era of subdued stock and bond market returns that most likely lies in prospect, fund costs will become more important than ever" (p. 125) Bogle's advice: "Diversify to the nth degree, minimize expenses, focus your emotions where they cannot wreak the kind of havoc that most others experience in their investment programs.…Emphasize all stock market index funds, carefully consider your risk tolerance and the portion of your investments you allocate to equities. Then stay the course" (p. 126).

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