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Registered Investment Advisor

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DECEMBER 2007 COMMENTS

HAPPY HOLIDAYS

DECEMBER and EARLY JANUARY 2008 MARKET ACTIVITY

During December, each of the major US stock market indexes (S&P 500, Dow Jones Industrials, NASDAQ Composite), declined by less than 1%, while high-quality US bond prices also had small changes. International stock market indexes, both developed and emerging, also posted modest losses, but maintained their strong full year performance. (See page 2 for all monthly and YTD figures). These December results followed November, during which stock prices declined sharply and high-quality US bond prices rose.

However, the first three days of January, 2008, ending Friday the 4th, was a period of renewed significant declines in US stock prices. Reports indicating a slowing US economy, coupled with the potential for higher inflation from high oil prices, were the reported catalysts for the declines. This also had the effect of lowering interest yields on high quality bonds, thereby raising prices for those bonds. The international indexes were also down (approximately 3%), which was a smaller decline than the US indexes (see chart on page 5).

While last month's Comments focused on the reported reasons for the significant November price declines, this month's Comments will focus on actions that can be taken during periods when prices show substantial changes (discussion starts on page 5).

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Also Years 1999 – 2006, and Various Other Longer Time Periods
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Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

COMMENTS: INDEX RESULTS for period ending DECEMBER 2007

<u>STOCKS</u>	<u>YEAR</u> <u>1999</u>	<u>YEARS</u> <u>2000-02</u>	<u>YEARS</u> <u>2003-05</u>	<u>YEAR</u> <u>2006</u>	<u>YTD</u> <u>2007</u>	<u>DEC</u> <u>2007</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	5.5%	(0.6)%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	3.5%	(0.9)%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	12.6%	0.2%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	0.1%	(1.5)%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	6.4%	(0.9)%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	9.8%	(0.4)%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	6.0%	(0.1)%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	1.2%	(0.7)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	15.5%	(2.7)%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	39.0%	(0.4)%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	(16.5)%	(4.5)%
 <u>BONDS</u>						
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	6.9%	0.3%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	3.4%	0.3%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	7.2%	0.3%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	4.2%	0.5%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	2.0%	0.5%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	11.6%	(0.2)%

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.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
		<u>1999</u>				<u>2000</u>				<u>2001</u>		
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.												
		<u>2002</u>				<u>2003</u>				<u>2004</u>		
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.												
		<u>2005</u>				<u>2006</u>				<u>2007</u>		
S&P 500	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2	5.8	1.6	(4.1)
NASDAQ	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3	7.5	4.0	(2.0)
BONDS	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4	(0.6)	2.9	3.2
Interm. Tax.												

DECEMBER 2007 COMMENTS

STOCK index prices for US and international stocks posted slight declines in December, following the significant declines of November.

Even with the November-December declines, the broad-based US stock indexes finished the year with gains, in a range of +3.5% (S&P 500) to +9.8% (NASDAQ Composite). Sector results showed wide variances: Financial and housing-related stocks had double digit declines, while technology and energy posted double digit gains. Developed International and Emerging Market International stocks continued to outperform the US indexes (YTD, +15.5 % and +39.0 % respectively), while the REIT sector continued as this year's underperformer, down 16.5% after years of outperformance. Growth stocks, after years of underperformance, strongly outperformed Value stocks (+12.6% to +0.1%). See page 2 for figures for the month, YTD, and since 1999.

BOND returns (price change plus interest) for the high credit quality part of the bond market were positive for the month; prices were basically unchanged, so the return came from the interest earned. Lower credit quality debt posted similar results. High credit quality bond returns, at +6.9% YTD, outperformed the returns for the Total Stock Market index, at +5.5%. Inflation Protected Treasury Bonds were +11.6% YTD. The benchmark 10-year US Treasury yield closed at 4.02%, slightly higher than November's 3.97%, but far, far below the summer high of 5.25%. The short-term rate controlled by the Federal Reserve was lowered by _ of 1%, to 4.25%, so short-term rates are now significantly higher than longer-term rates. Bond returns for the month, YTD, and since 1999 are set out on page 2 above.

ECONOMIC NEWS impacting this month's price movements, and the first week of 2008, is discussed starting at the bottom of page 5.

From a longer-term standpoint, the current decade has seen a major bear market in stocks (3/00-3/03), followed by a more than 4 _-year recovery to current price levels. Relative to their 2000 highs, the Dow Industrials are 13% higher, the S&P 500 4% lower, and the NASDAQ still a stunning 47% lower. Thus, the annualized returns for all three indexes since 2000 are far below their long-term average annualized returns. 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%.

However, going back further to the bull market that began in 1995, all three major indexes have remarkably similar average annual returns (ranging from 9.4% to 10.2%), slightly below the 10.4% average annual return for stocks dating back to 1926. As these returns converge, "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), seems apparent. But Vanguard's observation is also meaningful, since annual returns during the bull market were far higher than the long-term averages, and the eight year returns from 2000- 2007 have been 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.

	<u>S&P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
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 End 2007	1,468	(4)%	13,265	+13%	2,652	(47)%

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

	<u>S&P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. %Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
DECEMBER 2007	1,468	13,265	2,652
Gain	1,009	9,431	1,900
Avg. Ann. %Gain: '95-12/07; 13 yrs	9.4%	10.0 %	10.2 %

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

INVESTMENT CONCEPTS: REACTING TO SHARP MARKET PRICE CHANGES

The chart below, which we used in November's Comments, has been updated to reflect the modest price changes of December, and the more significant price declines of the first few days of January, 2008.

	<u>S&P 500</u>	<u>YTD % Change</u>	<u>Dow Jones Industrials</u>	<u>YTD % Change</u>	<u>NASDAQ Composite</u>	<u>YTD % Change</u>
Year End 2006	1,418	-	12,463	-	2,415	-
July 19 High	1,553	+9.5%	14,000	+12.3%	2,720	+12.6%
Aug 16 Intraday Low	1,370	(3.4%)	12,456	(0.0%)	2,387	(1.2%)
Oct 9 High	1,565	+10.4%	14,165	+13.7%	2,859	+18.4%
Nov 26 Low	1,407	(0.8%)	12,743	+ 2.2%	2,541	+5.2%
Nov 30 Close	1,481	+4.4%	13,372	+9.1%	2,661	+10.2%
Dec 31 Close	1,468	+3.5%	13,265	+6.4%	2,652	+9.8%
Jan. 4, 2008 Close	1,412	(0.5%)	12,800	+2.7%	2,505	+3.7%

Two key points to take from the chart:

- 1) From the end of 2006 to the January 4, 2008 close, returns for all three indexes are well below long-term average annual returns, but still higher than the August 16th lows.
- 2) The highs for this period (October 9th) were achieved less than two months after the August lows, and involved a swing of 14%. This points to the dangers of exiting the stock market after a period of declines, on the assumption the declines will continue. Notice also the 5% price rebound in the one week from November 26th to November 30th.

Before considering the various actions that might be taken in the face of declining stock prices, it is worth reviewing the current economic environment to understand some of the factors involved.

- 1) A weak employment report. "The unemployment rate rose sharply in December to its highest level in more than two years, raising the likelihood of a recession as the housing slump begins eating away at the previously sturdy household incomes that had been a pillar of the economy....In recent months, the labor market had been relatively resilient, with moderate job growth supporting gains in personal income and consumer spending. But with conditions deteriorating, the risk is that growth in spending, which accounts for more than two-thirds of the nation's economy, might skid to a halt" (WSJ, 1/5-6/08, front page).

2) High oil prices. "Oil and gold futures closed at all time highs," creating problems for stock prices, "as mounting fears for the economy sent investors to places they consider safer than stocks...Prices of Treasury bonds soared, pushing the benchmark 10-year bond yield to 3.90%" (WSJ, 1/3/08, front page). In the same article, it is noted that the current \$100 per barrel oil price is still just below the inflation adjusted all-time high price of \$103 set in 1980, and that the current \$857 an ounce price of gold is still far below the inflation adjusted high of \$2,120 from 1980. In an editorial (WSJ, 1/4/08, A10), the writers make the argument that the declining value of the dollar is very much a factor in the high price of oil, since oil prices are denominated in dollars, and producers are unwilling to sell their product and effectively be compensated with less purchasing power. The editorial acknowledges that while a declining dollar may stimulate exports, it is a real negative in terms of what Americans pay domestically for oil.

3) A slowdown in manufacturing activity. "A key measure of US manufacturing contracted sharply in December, in a sign that recent strength in export-related businesses is being swamped by problems in housing and other parts of the domestic economy. Until now, factories have shown resilience in the face of housing turmoil and high oil prices, but the latest figures from the factory floor are heightening recession worries and confirm the view that the slowdown is spilling over to a growing list of goods-producing industries" (WSJ, 1/2/08, A3).

4) Inflation fears could limit the Federal Reserve's ability to lower interest rates to help boost economic activity. "Slowing factory activity, weakening job growth, and a credit crunch have investors expecting aggressive interest rate cuts from the Federal Reserve. But this week's surge in the prices of oil and gold underlines why the Fed may not have as much freedom to ease monetary policy as much as it did in 2001, when the economy slumped, or as much as many on Wall Street want...The real disconnect is over inflation. The Fed thinks it is a bigger risk than it was in 2001...which forces the Fed to accept a greater risk of recession...which could mean either fewer rate cuts...or a quicker reversal of rate cuts" (WSJ, 1/4/08, A3).

5) A high degree of uncertainty over corporate earnings. In a column discussing corporate earnings ("Ahead of the Tape" WSJ, 1/7/08, C1), the writer states that "companies outside the sub-prime battered housing and financial sectors are expected to turn in solid numbers, with fourth quarter earnings excluding financial companies expected to be up 12% from a year earlier. If non-financial companies deliver, the stock market could be primed for positive surprises, given the gloom that now hangs over the market. But delivering won't be easy." The article continues by discussing the issues surrounding meeting the hoped-for earnings results, which are somewhat beyond the scope of this discussion.

We have identified from recent news articles five major areas of current concern: Weak employment, high oil prices, manufacturing slowdown, inflation fears, and uncertain corporate earnings. So the question now turns to what actions, if any, should be taken by investors concerned about the declining stock prices and rising high-quality bond prices caused by declining interest rates.

The possibilities include:

1) Doing nothing, i.e. relying on the appropriateness of your allocation to stocks and bonds, and accepting the price fluctuations as normal variations on the way to achieving favorable long-term average annual historical investment returns from the stock and bond markets. (These averages have been approximately 10% and 5%, respectively, before adjusting for inflation of approximately 3%). This approach assumes investments in broad-based indexes that track various markets, and not individual stocks, which can, and occasionally do, fail.

2) Trying to time the markets, which involves selling ahead of price declines, and then buying back at some point before prices recover and move beyond their prior highs. This approach is premised on the idea the investor can ascertain what is likely to happen in the future, since the markets have already reacted to the news, and endlessly debate the implications of that news. This approach can be used with broad-based indexes and/or individual stocks (also applies to approaches (3) and (4) below).

3) Using an approach referred to as momentum investing, which involves buying when prices are rising and selling when they are declining. This approach is premised on the idea that market trends continue for some period of time, and that one can profit from following those trends. It is often utilized by traders looking to profit from short-term market price changes.

4) Using an approach referred to as contrarian investing, which involves buying parts of the stock market that have declined more significantly than other parts, anticipating a larger recovery in those prices than the stock market as a whole. This has a similar rationale to the rebalancing approach discussed below, but does not come with the discipline of acting based on pre-determined percentages.

5) Using an approach referred to as rebalancing, which involves buying the asset category that has declined by a pre-determined percentage, and selling the asset category that has increased by a pre-determined percentage. This approach is premised on the idea that prices/investment returns tend to revert to their long term averages, and that buying the asset that is down and selling the one that is up is the best way to take advantage of this tendency. Remember that David Swensen, Yale University's chief investment manager, has described this idea of "regression to the mean" as "one of the most powerful influences in the world of finance" (see page 4).

At Park Piedmont, we use a combination of approaches (1) and (5). Our basic methodology is to: (a) provide our clients with asset allocation advice appropriate to their particular circumstances, designed to allow them to mostly ignore market price fluctuations; and (b) implement the allocation advice with a broad mix of indexed investments and certain specialized investments designed to provide additional diversification. This methodology lends itself to a long-term, buy-and-hold strategy, which in turn suggests that in the face of market price changes, the better approach is to do nothing. We also think the discipline involved in the buy low/sell high methodology of rebalancing offers the potential to add to long-term investment results. Further, we think the problems associated with the more active, timing efforts of alternatives (2), (3), and (4) outweigh whatever potential advantages they may offer.

Timing, momentum and contrarian investing all involve active decision-making about the future direction of market prices. Whether evaluating corporate earnings results, the likely economic data that affects those earnings, or the multiples of earnings that make for stock prices, the active decision-maker, whether amateur or professional, needs to be able to assess all known facts, make reasonably accurate judgments about future events and their likely consequences, and then choose investments that are going to do better, in some given time period, than the results of the broad based market itself. With so many knowledgeable market participants reaching different conclusions every day, we think this effort of trying to outthink the overall market is not productive. Some may outperform for a while, but long-term, consistent outperformance is highly unlikely. (Swensen has written extensively about this in his book for individual investors, "Unconventional Success," which we have quoted from in the past, and use as one of our basic sources of professional support). Even those few who have achieved prominence as highly successful investors (think Warren Buffett) advise individual investors to invest for the long term, using low-cost, broad-based indexes.

Rebalancing involves setting percentage change figures in advance of the change, and then acting if and when that percentage change occurs. For example: An investor who starts with a 50-50 allocation, and uses a 10% change in the allocation as a signal to act, would then sell the asset that has risen to 60% and buy the asset that had declined to 40%, thereby reestablishing the initial 50-50 allocation. This is a buy low/sell high discipline, with the percentage established in advance of the actual price movements. Presumably, buying at lower prices should enhance long-term results. However, this approach reduces gains if the higher performing asset class continues to move higher still (since some of that asset was sold), and can add to declines if the lower performing asset class continues to decline (since more of that asset was bought). It also highlights the importance of the initial allocation. Further, if the regression back to the long-term average return does not materialize (example: the Japanese stock market, measured by the Nikkei index, remains today more than 60% below its all time high, reached at the end of 1989), or takes considerably longer than expected (possible example: the S&P 500 index in the US, even with five consecutive years of gains, is still below its all time high reached in March 2000), this rebalancing approach may disappoint.

In summary, there is no one correct answer to the question of how best to respond to significant market price declines. Most of Wall Street tries to convince its clients that their particular active approach is best. We prefer to rely on the long-term aspects of investing, and focus on maintaining an asset allocation for our clients that minimizes their exposure to serious downside price movements, as long as that allocation allows a reasonable chance for the client to achieve his/her overall financial objective.



Victor Levinson



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