

The End (of 2007) is Near

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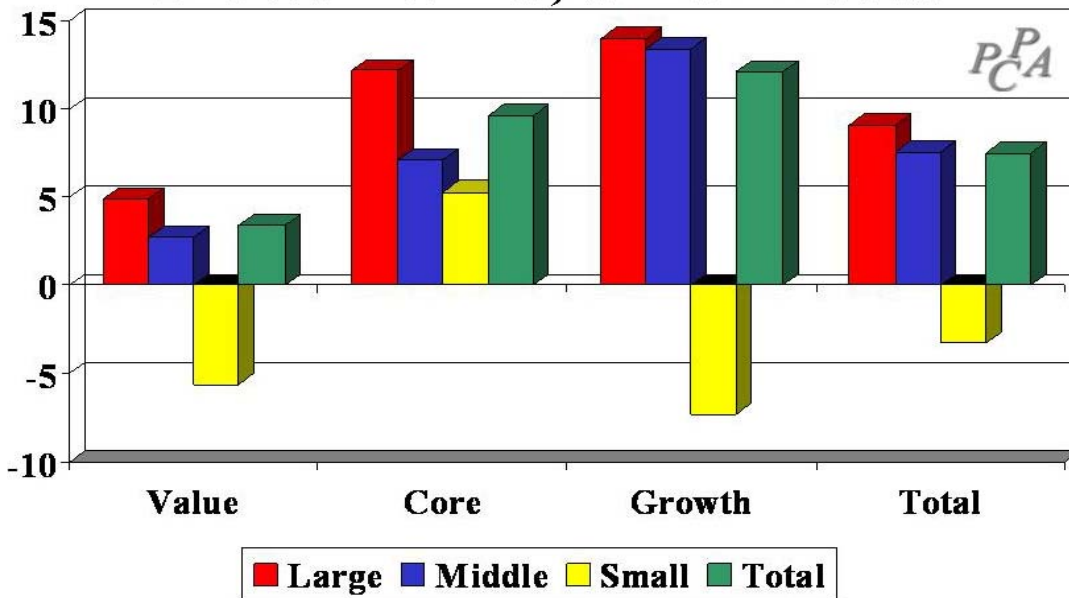
December 6, 2007

The following commentary summarizes stock market performance for the year to date through November, 2007. We first examine domestic style and sector returns, and then move outside the US where results have been substantially better. We also provide some helpful tools for those interested in performance attribution and for the growing list of those interested in target date lifecycle funds. These are gifts for you in this holiday season at the end of this commentary, so be sure to take them. We hope you find these insights of value and would appreciate your feedback. Our stories are told with pictures that you should find helpful to client servicing and reporting.

Year-to-date US Returns Suffer November Setback

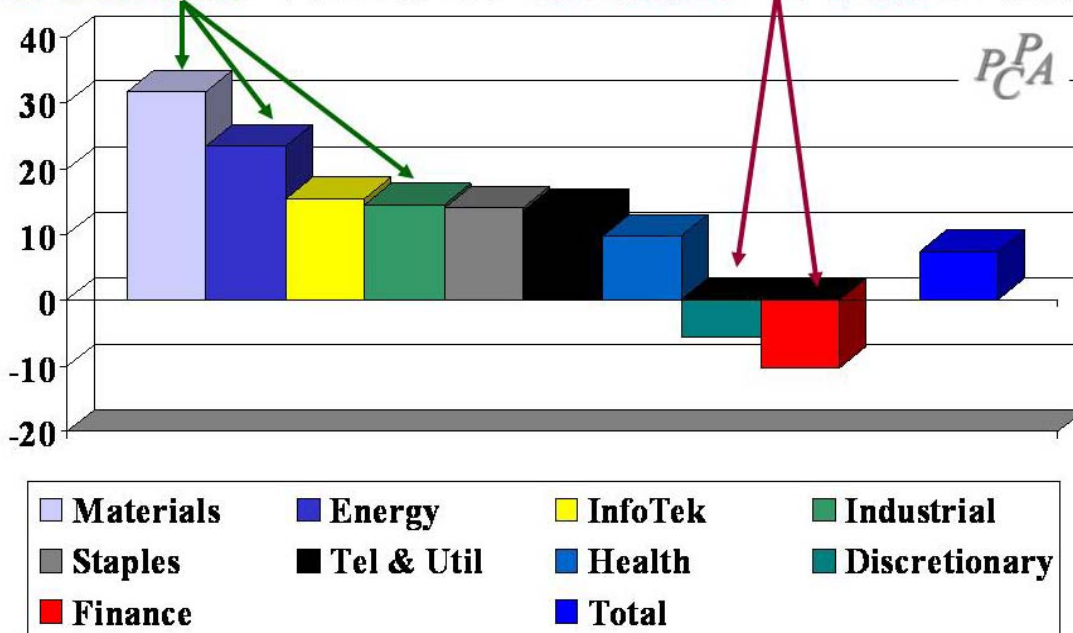
It was looking like 2007 was going to be a double digit return year, with returns near 13% through October. But that all changed in November when the market retreated 5%, due primarily to credit woes, especially those in the sub-prime market. So now the year-to-date return through November is just 7.5%, below the long-term average returns on US stocks of 10% per year. Growth stocks have fared best, returning 12%, especially large cap growth with a 14% return. It's been a long time since we last saw growth in the lead. By contrast, small companies, defined as those in the bottom 10% of capitalization, have lost 3% of their value so far this year. We use Surz Styles throughout this commentary, as described at [<Surz Styles>](#).

U.S. Style Returns Growth Wins; Small Loses



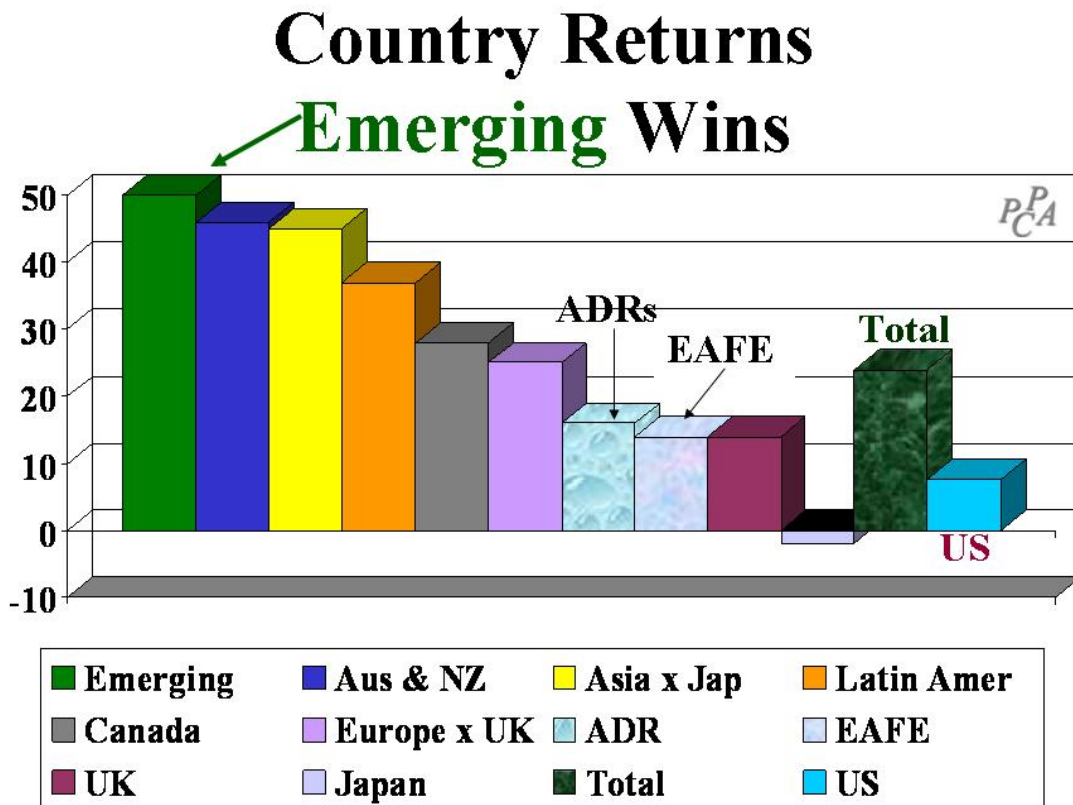
Sector analyses reveal that the Chindia effect, driven by the growth in China and India, continues to advantage U.S. industrial-related sectors – materials, energy and industrial. At the same time, domestic credit concerns have led to losses in both the financial and consumer discretionary sectors.

U.S. Sector Returns Chindia Wins & Credit Woes Lose



Foreign Markets: Thrice as Good

Foreign markets have earned 24% through November, more than tripling U.S. returns. The Chindia effect had propelled Asia ex Japan into the lead through the third quarter, but Emerging Markets and Australia & New Zealand have since outpaced Asia ex Japan to take the lead. Including some non-EAFE countries and companies in your portfolio has made a big difference this year. EAFE excludes some of the best performing countries in the world, and has generally underperformed where it has country exposure because smaller companies have fared best. As you can see, EAFE lags the total non-US market by 1000 basis points. The ADR (American Depository Receipt) market has fared somewhat better than EAFE, but still lags the broad market somewhat.



'Tis the Season: A Couple of Gifts



Target date lifecycle funds are a big deal, so I've teamed up with a couple of industry experts to create Target Date Analytics (TDA). TDA provides educational papers, benchmarks, and analyses of target date mutual fund performance, all for free -- **our gifts to you. Please visit us at www.TDBench.com.**

A second gift comes in the form of "Noble Challenges" facing our industry. I've contributed to a new book by that name. My chapter is about investment performance attribution. An excerpt follows. Please let me know if you'd like to see more.

Our best to you and yours in this joyous holiday season.

Excerpt from Chapter in "Noble Challenges" on Attribution

Investment performance attribution determines why performance is good or bad, singling out what worked and didn't work. In the hierarchy of the search for manager talent, attribution ranks way above evaluation and is far more forward looking. The skillful can stumble and the unskilled can get lucky. We want to know the difference, and importantly we want to know how mistakes are being corrected and what proficiencies are being groomed. Some of the "Noble Challenges", the title of this book, in performance attribution are as follows:

- ✚ [Differentiating not just between luck and skill, but between style, luck and skill.](#) The relatively recent awareness of the importance of style goes a long way toward identifying true skill. It's easy to confuse style with skill but extremely difficult to make good decisions in the face of this mistake. Buying skill, not style, is akin to buying alpha not beta.
- ✚ [Dealing with the active-passive trade-off.](#) Use all the active managers you can find who have demonstrated skill, and complete the portfolio with passive investments to

fill in parts of the market where talent has not been found. It should only matter that the manager adds value, not that value is added in a particular style box.

- ✚ [Putting style boxes to good use.](#) Insisting that a manager fit in a box is absurd. We miss too much talent that way, and end up with mostly index huggers. No offense to index huggers, but most skillful managers can't deliver under the constraint of living in a box. Rather, investment managers should be evaluated against custom style blends that reflect their people, process and philosophy. The due diligence process involves 2 central questions: (1) Do we like what this manager does? and (2) Does (s)he do it well? The answer to the first question shouldn't revolve around style boxes, rather blended boxes should be used to answer the second question.
- ✚ [Regaining control of the assets.](#) Financial consultants and institutional investors have relinquished control of their assets to investment managers, primarily through terrific sales and account management that manipulates the client in various ways, including creative performance reporting. Granted, investment managers are the smarter lot, but the assets are not theirs.
- ✚ [Compensating investment professionals for delivering value added.](#) Specifically, attribution determines which analysts are succeeding and failing, as well as the effects of the portfolio managers on overall performance. Knowing which players own which pieces of the performance puzzle, as well as who is contributing and who is not, is important for professional retention and morale. Compensation should be tied to contribution. Unfortunately, bonuses are typically based on ad hoc rules of thumb that ultimately make them fully discretionary. This creates a dynamic that rewards dominant personalities and pointy-haired bosses rather than talent.

To address these challenges, performance attribution must take away all of the hiding places that managers have used for the past 40 years, which is the relatively short history of this profession. Fair is fair, and it's time for investors to get the real story; all of the cards in this poker game need to be dealt up. This chapter goes beyond the valiant efforts of the CFA Institute and its Global Investment Performance Standards (GIPs). The GIPs standards focus primarily on accurate measurements and reporting, but even the most accurate measurements can be misinterpreted when compared to faulty benchmarks, regardless of the intent. And once the benchmark is wrong, all of the analytics, including attribution, are wrong.