

GREEN INVESTMENT MANAGEMENT, INC.

309 W 7th Street • Suite 101 • Fort Worth, Texas 76102-6901

Toll Free (800)950-8004 • Phone (817)335-1178 • Fax (817)877-0741

Web Site: www.GIMlink.com

Volume 16, Issue 1

January 31, 2007

Market Commentary

A Review of the Markets and a Look into the Future

Fed Stalls, Stocks Pause

Ninety percent of what passes for brilliance or incompetence in investing is the ebb and flow of investment style - growth, value, small, foreign.

- Jeremy Grantham

A well designed asset allocation strategy is the best way for you to achieve your long-term goals. Inherent in the whole concept of asset allocation is the idea that different assets, such as stocks, bonds, real estate or commodities, will perform differently. Yet, combined together in the right proportions, these assets enhance the long-term predictability of the risk and returns your portfolio is likely to experience.

In deciding which asset classes to include in your portfolio and in what proportions, it is important to consider the risk of each component, its expected return and its correlation or movement in relationship to the other assets. This can most easily be accomplished through the use of software designed for that purpose. Through this method of diversification, portfolio risk can be minimized for a given level of expected return. In other words, the chances of achieving your financial goals are enhanced through the use of an appropriate asset allocation strategy. These concepts were first pioneered by Harry Markowitz back in 1952 (known as the father of Modern Portfolio Theory 'MPT') and are incorporated into the work Green Investment Management (GIM) does on your behalf.

Beyond Markowitz's MPT, GIM takes the asset allocation decision one step further by adding a tactical overlay to your base or strategic allocation (such as the Guardian Balanced Allocation or any 12 of our other allocation strategies in which you may be invested). A tactical overlay simply means GIM will occasionally overweight or underweight assets in your portfolio with relationship to the base allocation you have chosen. These tactical adjustments to your portfolio may be precipitated by a number of factors, such as an asset class becoming significantly overvalued or undervalued, a change in the economic outlook that may impact the performance of one or more assets, or special situations that arise when they are least expected, such as catastrophes - natural (Hurricane Katrina) or otherwise (9/11). Our reallocation goal may be to reduce the overall volatility of your portfolio or to enhance its returns consistent with your risk tolerance.

The foregoing review of our methodologies at GIM was done at the risk of boring some of our readers. If you fall into that group,

we appreciate your indulgence. We feel it is important to periodically inform or remind our readers of the disciplined process we go through to improve your opportunities for success. In the following paragraphs, we will look at each of the asset classes that may comprise your portfolio from time-to-time and assess their current outlook.

Equities

During the last six months we have been fortunate to experience some very favorable returns from equities, especially foreign equities. The advance began in late July as investors sensed a potential end to the Federal Reserve (Fed) tightening campaign which had persisted for two straight years. Economic data had begun to suggest the possibility of a soft landing (i.e., an economic slowdown absent the deleterious affects of a recession) accompanied by resilient corporate earnings.

In spite of the strong advances in equities, inflationary pressures have persisted and continue to be elevated today. With this in mind, the Fed is unlikely to cut interest rates until the economy is clearly weakening. Recent economic releases may actually point more toward a reacceleration. This fact is reflected in 10-year Treasury yields which have risen almost ½% (i.e., a 10% increase) from their December lows. If bond investor's assessment of the economic terrain ahead proves to be correct, there is a risk stocks may once again have to price in the possibility of resumption in Fed tightening.

Many of you may recall from your college economics course the 'Phillips Curve' and its explanation of the relationship between inflation and unemployment. It essentially explained that when inflation is high, unemployment tends to be low (i.e., when there is solid economic growth), and vice-versa. Simply put, governments must make a decision to accept higher levels of inflation in order to maintain low unemployment levels or be willing to experience higher unemployment in order to put downward pressure on inflation. Over the years this trade-off has generally held true, but less so in recent years. According to BCA Research's *Strategy Outlook – Part 1, First Quarter 2007*, since

the mid 90's the Phillips Curve has been flattening, allowing economies to grow faster than ever before without generating excessive inflation. BCA asserts that the deflationary impact of globalization, corporate restructuring across the globe, and massive capital spending is the cause of this flattening of the Phillips Curve. As such, the relationship between growth and inflation has become less direct. Today, many economies of the world are growing very rapidly with little inflationary pressures.

The bottom line for domestic equities is that resurging growth, to the extent it happens, will not likely cause a meaningful rebound in inflation in the current global environment. However, it might increase the risk the Fed might raise rates again as an insurance policy against that possibility. But given the observations in the paragraph above, it is not likely the Fed would have to do very much more to suppress inflation in this environment.

In the coming days a number of important economic reports will be released, including the Payroll Report and the ISM Manufacturing Index. These key releases should begin to unfold a clearer picture of whether the economy is indeed accelerating. Presently GIM has a moderately defensive posture awaiting a clearer picture of the near-term outlook. If the upcoming data supports the premise of an accelerating economy, we would expect a near-term correction as the market puts back some of the risk premium it took away when it first began to expect the Fed was finished. Conversely, if the data is more consistent with a moderating economy, we would expect bond yields to moderately weaken and the stock market to resume its uptrend. In that eventuality, GIM will likely increase your domestic equity allocations back to at least their strategic targets.

Regardless of which of the aforementioned scenarios unfold in the coming weeks, GIM expects a similar final outcome for the year as a whole. Equity valuations are currently reasonable, corporate balance sheets are generally sound and the global economy is healthy. With S&P 500 earnings projected to rise approximately 9% for 2007, GIM thinks it is reasonable to anticipate returns of around 9% for the S&P 500. Additional returns could result if P/E multiples expand from their current moderate levels (i.e., 17.9x trailing earnings and 15x expected earnings).

Within domestic equities we currently favor large-cap stocks over small-caps and modestly favor value over growth. Globally, we favor foreign equities over domestic - primarily due to three factors:

1. generally better valuations,
2. generally lower interest rates, and
3. Insulated from a potential dollar slide

Bonds

In the event the Fed is ultimately successful in orchestrating a soft landing, - and we think they will be - longer-dated bond yields should gradually rise as growth prospects begin to improve, thereby driving bond prices lower. The yield on shorter maturities would likely decline, driven by a Fed induced

reduction in short-term rates, leading to higher bond prices. Therefore, there should be a bias for owning shorter dated bonds currently. Not only are their yields comparable to longer-dated bonds, but their opportunity for capital gains are enhanced in the current environment.

As far as speculative grade bonds, Standard and Poor's Global Fixed Income Research expects default rates to rise from their near record lows in 2006 of 1.26% to end 2007 with rates in the 2.5% - 3% range. S&P predicts this increase will cause credit spreads (the surplus yield of speculative bonds over investment grade bonds) to widen by 101 basis points (approximately 1%). To the extent this happens, returns on high yield bonds will be penalized as the spreads widen. The good news is wider spreads should better compensate investors for the additional risk speculative bonds present.

Commodities

Academic research supports the fact that commodities, in appropriate proportions, provide a tremendous benefit to a diversified portfolio because of their positive long-term returns and low level of correlation with the other assets in the portfolio. GIM allocations do not currently have a diversified commodity holding within our portfolios, but we are evaluating an appropriate entry point in the coming months. The long-term prospects for commodities are driven by huge demands coming from the developing markets, especially China and India.

Real Estate

Much like commodities, real estate can be a real compliment to a diversified portfolio. In recent years, Real Estate Investment Trusts (REITS) have experienced outsized returns relative to historical norms and are now priced at levels that make them a less attractive holding relative to some other alternatives, especially equities. In the meantime, GIM will continue to monitor their valuations and outlook in search for an attractive future entry point.

Conclusion

The economy and the markets appear to be poised to have a good year in 2007. However, surprises will surely present themselves. Have confidence! In the final analysis a disciplined asset allocation approach based upon the underlying fundamentals of the markets and grounded in modern portfolio theory will have more of a long-term influence on the performance of your portfolio than any single surprise that may appear.

The views expressed are those of Byron Green as of January 31, 2007, and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor.