

The Quarterly

Newsletter

Volume 1, Issue 1 Sept, 2008

**Global Indexes 5 year return
(August 08)**

- Dow:**
- S&P 500:**
- Russell 3000:**
- Nasdaq:**
- EAFE:**
- EuroStoxx 350:**
- Emerging Markets:**
- US Bond Aggregate:**
- Hi Yield Bonds:**
- Gold:**
- Oil:**
- US REITs:**
- Dollar Index:**

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The Paradigm Shift

Houghton Capital Management is making the call that index-based investing is the second significant paradigm shift in the investment world since the emphasis on global investment diversification took hold in the early 1990s.

The first major paradigm shift widely changed investment landscape and the portfolios of American investors, who prior to that time only had marginal allocations to international assets.

In the early '90s there was little in the financial press discussing international investing and even fewer investment professionals who advocated including foreign assets in US investors' portfolios. Over the course of the 1990s, this mindset changed radically. Today, many investment profession-

als now insist on allocating 20% or more of a client's portfolio to international investments.

Houghton asserts that the second major paradigm shift is underway, but still in its early stages. While the discussion of index based-investing is more prevalent, the percentage allocation to clients' portfolios is less prevalent. Many investors and money management firms still believe that asset selection and market timing will produce superior investment returns. However, academic and empirical research has proven them wrong.

Old is New Again.

That is certainly applicable to the world of index investing. While index investing first came on the scene in

the early 1950s as a theory put forward by John Bogle, who went on to found Vanguard Investments, and the work of Nobel Laureates Fama and French, it has only come into its own in recent years. The first index fund was established in 1971. John Bogle founded Vanguard Investments in the 1970s with the expressed goal of promoting index investing and other low-cost investment strategies.

Through the 1980s and 1990s mutual funds and separately managed accounts proliferated and became the main way investors chose or had their investments chosen for them. Often, the financial services industry created products to suit an investment (continued on page 2)

Principals' Welcoming Remarks: & Cores and Satellites

Houghton Capital is named for the location of the London School of Economics and Political Science (both Principals studied there).

We have come to the conclusion after years of participating in more traditional

"active" management trying to pick stocks, funds and other securities, that the best way to invest the majority of almost every client's portfolio is by using indexes.

Our model portfolios are built using baskets of stock

and bond index funds, representing the largest most liquid and developed markets. More aggressive portfolios will have a significant portion of what we call "satellite alphas".

(continued . on page 2).

Principals' Welcoming Remarks-continued from front page

The core of every portfolio should be a set of assets which rarely changes. These would represent the main global stock and bond indexes that we believe every investor needs to have exposure to. The "satellites" would be asset classes which Houghton believes represent good value due to macroeconomic or microeconomic conditions and would never represent more than about 15% of even the most aggressively allocated portfolios. The "satellite alphas" as we refer to them, would usually also be represented by index funds. They might represent a particular business sector which has been beaten down, or a certain section of the US market trading at historic lows, or a for-

eign, less developed market which Houghton believes represents an opportunity. We believe that such allocations are by no means a deviation from our index based investment approach but rather provide an element of opportunistic flexibility in the allocation process. Indeed, more likely than not there may be times when this allocation flexibility will not be employed at all.

Again, We do not pick stocks or bonds, but rather broader asset classes to diversify the risk and avoiding resting your success on the opinions of analysts and rating agencies, which we believe have been disappointing investors for years.

Economic Data Points:

Global GDP Growth:

US GDP Growth:

US Inflation:

US Unemployment:

US Prime Rate:

ECB Rate:

Bank Of Japan:

30 year fixed:

The Paradigm Shift-continued from front page

fad or bubble of the moment (remember the Internet Funds of the late 1990s?). These were often expensive and tax inefficient ways to invest.

They rarely outperformed their benchmarks. Morningstar, the Chicago-based, impartial research group, has repeatedly published surveys which show that less than

20 percent of mutual fund or other types of money managers beat the performance of the main US stock market index, the Standard and Poor's 500.

In some 5 year periods, the number of managers who outperform their benchmark is less than 10%, especially when trading costs and other fees are included.

"We are in the midst of the second significant investment paradigm shift since 1990"

Global Equity Review and Outlook

Stocks outside the US represent about 54% of total world stock market capitalization. In today's capital market you must hold foreign stocks. The last five years have been proof that a well-diversified portfolio is beneficial. Foreign Equities have outperformed US Stocks by about 8% compounded annually.

The weak dollar and valuation expansion has been the primary source of the excess return, and not excess earnings growth. Strong currency, banking problems, and higher rates will take their toll on foreign equities. The valuation of global stocks is now 140% of US Valuation. Selected Emerging Mar-

kets will do well. We anticipate that this area will be more in line with US stock market returns in the coming years. Having traveled to Japan over the past few years, we continue to find Japanese equity markets interesting. We suggest reviewing portfolios for any markets which have become overweight.

Keeping Perspectives in Troubling Times

Is there a right time to invest?

The U.S. financial system has faced many instances of dislocation in its 230 plus year history. Penn Central and Continental Bank of Chicago suffered failure after energy loans in '70s. Real estate suffered terribly in the early '80s. The early 1990s were no picnic either. The S & L failures were a \$180 billion taxpayer debacle. Today's mortgage markets meltdown appears to be reaching the \$1 trillion level globally. Bond holders were massacred during inflation of the '70s. The question of what is real and what is noise is always difficult.

We deal with three aspects when making portfolio decisions: return, risk and uncertainty. The word "surprise" would not exist with out uncertainty. As humans we, many

recognize our inability to predict future outcomes. Uncertainty is a regular feature of the global stock markets.

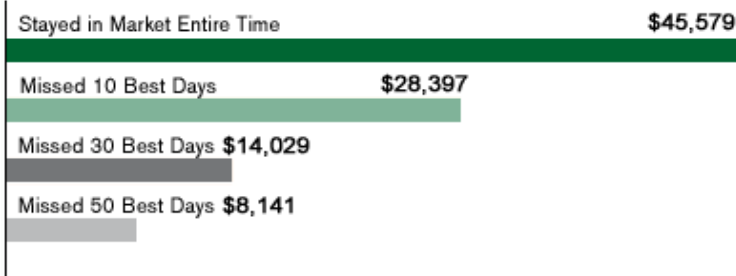
Many professional investors, as well as legions of Uncle Harry's and Brothers-in-Law, will insist they have an investment tip. However, academic research shows clearly that over the past nearly 20 years, trying to time the market simply does not work. In some rare cases where it does, often the costs associated with trading, tax, and lost sleep far outweigh any benefits received. The press will be quick to highlight and interview the one manager in the haystack full of managers who can beat the market, but past performance never predicts future results. Bill Miller from Legg

Mason beat the S&P 500 for 14 years running. His results have lagged for the past 2 years. The expense ratio on the fund is .xxx.

At Houghton, we have reviewed the past 75 years of stock and bond market history and found that almost every year has some event which could cause an investor to enter or exit the market. Long run stock market returns in the US have exceeded almost every other asset class in our lifetimes. The key to keeping perspective is to pick a level of risk you can withstand and stay invested. And realize surprise exists. Please see our website www.houghtonllc.com to view the 75 year chart.

Think you can Time the Market? Take Pause.....

Growth of \$10,000 in an Investment that Performed Similarly to the S&P 500 Index¹
From December 1991 to December 2006



¹Source: Bloomberg.

Nobel Laureate Research shows that it is almost impossible to beat the market by picking stocks or timing it

Indices and Index ETFs defined

An index is a collection of securities intended to represent a market or given segment of the market.

An ETF is an investment vehicle that combines key features of traditional mutual funds and individual stocks. ETFs are open ended funds similar to index mutual funds, with the difference being that index ETFs can be

bought and sold like stocks....At Houghton we build portfolios using securities which track specific indices.

We restrict ourselves to the better-known and liquid index funds such as those from Vanguard and Barclays I-Shares, State Street and in some cases, Powershares.

The benefits of ETFs are lower costs than traditional mutual funds, diversification, and tax efficiency as a result of lower portfolio turnover.

Most uniquely, investors can use the modularity of ETFs to create portfolios with different asset-class and risk profiles.

Index-based Investing and the Nobel Laureates

Most investors don't know about the Nobel Laureate and other academic research on investing and index-based investing in particular. The most significant problem investors have is their reliance on factors other than empirical research to select their investments. Investors are mostly speculating and relying on Lady Luck rather than Nobel Laureates. They are most often chasing the recent success of a manager. The great majority of investors are unaware of the tremendous amount of academic brainpower that has been applied to investing. This lack of awareness makes investors more susceptible to the lure of active management, with spectacular recent performance numbers, and thereby taking on risks they do not understand. There is a stark contrast between a peer reviewed non-biased academic paper and an article in *The Wall Street Journal*, *Barron's*, *Forbes*, *Fortune*, *Money*, an analyst report, or the numerous other sources of investment research. Virtually every private investor is unaware of the vast amount of academic research that points to investing in portfolios of index funds, research which remains valid to this day.

Harry Markowitz, of the University of Chicago, the Nobel Prize Winner in Economics in 1990, first came up with The Efficient Market Theory in 1952. The theory explains the workings of free and efficient financial markets. Information about stocks is widely and cheaply available to all investors. All known and available information is already reflected in current stock prices. The price of a stock agreed on by a buyer and a seller is the best estimate, good or bad, of the investment value of that stock. Stock prices will almost instantaneously change as new unpredictable information about them appears in the market. All of these factors make it almost impossible to capture returns in excess of market returns, without taking greater than market levels of risk. It is relatively rare to find and profit from a mismatch between a stock's price and its value, or to identify an undervalued or overvalued stock through fundamental analysis of stocks. This creates efficient financial markets where most stock prices accurately reflect their true underlying investment values. Even when stock prices do not reflect their values, attempts to establish more accurate values usually cost more than the profit to be made from successful efforts to do so.

Paul Samuelson of MIT, the Nobel Prize Winner in Economics for 1970 was the first American to win the Nobel Prize. Samuelson insists there are no easy pickings and no sure gains when it comes to stock selection. Samuelson's wisdom is reflected in his words, "Investing should be dull, like watching paint dry or grass grow. If you want excitement, take \$800 and go to Las Vegas. It is not easy to get rich in Las Vegas, at Churchill Downs, or at the local Merrill Lynch office." An impressive collection of his research from 1937 to 1986 contains 388 articles that span 4,665 pages.

In Samuelson's 1965 paper, *Proof that Properly Anticipated Prices Fluctuate Randomly*, he describes "shadow prices" or true values of a security. Samuelson suggests that the best estimate of the true value of a security is the price that is set in the marketplace every minute of every trading day. Although these prices may not be the precise true value, no other estimate is likely to be more accurate than what buyers and sellers agree on in the marketplace. Of course, there is the opposing view of investment professionals who believe that there are constant differences between the market price and the true value of securities, and that those differences can result in future profits for the skilled money manager. Generally speaking, Paul Samuelson has contributed more than any other contemporary economist to raising the analytical and methodological level in economic science.

Anyone with evidence to the contrary has yet to show a comparably rigorous analysis of the facts. At the 1968 Institutional Investor conference, one irate money manager insisted that what he and others did for investors had to be worth more than just throwing darts at the *Wall Street Journal*. The "dart board portfolio" soon became a new benchmark for active investors, appearing in newspapers, magazines, and in a 1992 *20/20 ABC* news segment entitled, *Who Needs the Experts?* In that segment, a giant wall-sized version of the *Wall Street Journal* was made into a dartboard. Reporter John Stossel threw several darts as he described the firms he randomly hit. The results of that portfolio were compared to those of the major Wall Street Firm experts. The darts beat 90% of the experts! When ABC requested interviews with several of these expert firms, not one of them would speak or comment on their humiliating inability to beat the darts. **Paul Samuelson's findings can be summarized as follows: Market prices are the best estimates of value, price changes follow random patterns, and future stock prices are unpredictable.**

Eugene Fama, from the University of Chicago, a candidate for the Nobel Prize in Economics in 2003, is another pillar of modern finance. Building on the ideas of Samuelson and some others, Fama set out to develop a comprehensive theory to explain why stock market prices fluctuate randomly. He coined the famous phrase "Efficient Market." Fama worked for a stock market newsletter firm while attending undergraduate school in Boston. One of his duties was to find "buy and sell signals" based on certain market trends. He experienced firsthand the difficulty in predicting future market trends. He began to wonder, just as Cowles did before him, why it was so difficult to translate what appeared to be neatly defined past trends into sure methods of making money in the stock market. These ponderings influenced him enough to attend the University of Chicago, obtain his doctorate, and become a professor teaching classes on the works of Harry Markowitz. Despite the innovative character of Markowitz's writings and his association with Chicago, his work was virtually unknown when Fama first brought it to the attention of the finance department. Fama later applied his extensive, world famous research to create numerous index mutual funds at Dimensional Fund Advisors.

In January 1965, the *Journal of Business* published Fama's entire 70-page Ph.D. thesis, *The Behavior of Stock Market Prices*, summarized nine months later by the *Financial Analysts Journal* and titled "Random Walks in Stock Market Prices". Fama suggested that by utilizing the tremendous resources that a major brokerage firm can muster for researching industry trends, effects of interest rates, accounting data, and by talking to managers of firms, consulting economists and politicians, a security analyst should be able to consistently outperform a randomly selected portfolio of securities of the same general risk.

Since in any given situation, the analyst has a fifty percent chance of outperforming the random selection, even if his skills are nonexistent, Fama's conclusion was that the analysts do not consistently outperform a market.

Michael Jensen, a graduate student of Fama, in 1965 published "The Performance of Mutual Funds in the Period 1945-1965," in the *Journal of Finance*. This was the first study of actively managed mutual funds that documented their investment professionals' failure to outperform the appropriate market indexes. Jensen has made significant contributions to the academic literature. Michael Jensen ranks second out of 19,780 authors, at the Social Science Electronic Publishing online database, with over 46,000 downloads of his research papers.

Jensen also added a risk dimension when comparing mutual fund performance. He adjusted returns of funds using Sharpe's volatility measure, beta. This incorporated the idea that investors who take more risk should receive a higher return. Overperformance or underperformance of an index may be due to exposure to more or less risk than a comparable index. Jensen found that if investors had held a broadly based portfolio of common stocks at the same risk level as the mutual funds, they would have earned fifteen percent more. Only twenty-six out of one hundred fifteen funds outperformed the market over the period of the study.

Jensen's dramatic study opened the eyes of both the mutual fund industry and investors. He pointed out that fund managers have access to extensive research, and that they do their jobs every day with wide ranging contacts and associations in both the business and financial communities. Jensen's study did not consider the federal and state taxes on the realized gains generated by the high turnover of these mutual funds. That problem was later studied by Robert Arnott in his paper, *Can Your Alpha Cover Your Taxes?* Alpha refers to a manager's return in excess of a market. When adjusted for all relevant factors, a well defined index of stocks will always outperform the high cost of active manager trading within that index. The only way to get a return that is different from an index is to invest in a portfolio that is different from the index. Since the index is the only source of long-term risk and return data, why would an investor choose anything else?

Houghton's Asset Allocation Rationale

Houghton's Asset Allocation is largely market capitalization based, remaining true to our belief that successful investing is determined by participation and diversification in the markets and not by attempts to time them or willfully under or overweight them. 74% of global stock market capitalization is represented by the 15 largest markets.⁽¹⁾ Our asset allocation for our model portfolios will reflect this by deploying the most appropriate and cost effective index fund or ETF to reflect the relative weight of these markets. Our "satellite alpha" allocations representing special situations or circumstances currently focus on global financials, US home builders' global healthcare and perhaps certain developing markets which at this time may represent once-in-a-decade values and prices. Though Houghton largely refrains from selecting sector indexes and sector ETFs as this would only create a stock-picking mindset, there are some sectors we believe provide relatively rare opportunities. Picking sectors or stocks or attempting to time markets as a regular course continues to be saddled with all the inherent risks and uncertainties discussed in this letter. **Notwithstanding our satellite strategy we continue to place little emphasis on trying to time economic or business cycles.** The latest fashionable asset classes which Wall Street has tried to sell as the "new, new thing" do not interest us either. Whilst certainly capable of doing so, we do not employ economists or analysts though we certainly remain cognizant of global developments. Rather, and more importantly, we endeavor to remain knowledgeable of a client's particular situation that may be cause to adjust a client's portfolio.

Houghton's Investment Process

Is grounded in the belief of the efficiency of capital markets and that it is virtually impossible for any investor to consistently outperform any particular market (See Nobel laureate research). The recipe for success when investing in the capital; markets is not a result of stock selection, marketing timing, and excessive trading. Our Conservative Model Portfolio is a case-in-point. It contains mostly assets from developed markets, which have been historically less volatile than other markets such as Emerging Markets and commodities.

Fixed income investors are not left out of the index fund and ETF arena. We have the ability to assemble a fixed-income portfolio using Index Funds and ETFs, and to supplement them with individual issues as warranted.

Houghton's investment process for the client is a five part circular approach: Review of personal financial situation, construction of custom investment policy and plan, implementation, quarterly and annual review, and re-balancing when necessary.

Success is based on the mundane practice of asset allocation, adequate diversification, cost management, market participation and monitoring your risk reward profile. This in turn takes investing from a speculative experience to what we regard an "investment experience"!

Houghton's Value Proposition to You-Our Services

Selecting a suitable asset allocation and constructing an individually-tailored portfolio can be a daunting undertaking for investors. Today, there are dozens of markets and even more indices, index funds and ETFs worldwide that warrant consideration in a diversified portfolio. At Houghton, we monitor the markets daily, we compare results and risk levels, and build portfolios to suit different investors' needs and goals.

- Your relationship is with the Principals
- We listen, then act
- Select number of client relationships
- Regular newsletter and client education
- Liaise with your other professional advisors
- Deliver asset-class returns less index/mgmt. costs
- Analysis of investment and personal circumstances
- Develop and implement investment policy statement
- Monitor and review investment process
- Provide clear, prompt and accurate reporting

Houghton Global Asset Allocation Models

- Russell 3000
- MSCI EAFE+Canada
- MS EMkts Glb
- Lehman US Aggregate
- Merrl HiYld
- Citi WGBI ex US >5
- Citi USD TBill 3M



Portfolio Allocations

Name	Conservative	Global Balanced	Growth
Russell 3000	15.00%	27.50%	35.00%
MSCI EAFE+Canada	14.00%	25.90%	32.00%
MS EMkts Glb	2.00%	4.10%	5.00%
Lehman US Aggregate	30.00%	18.10%	12.00%
Merrl HiYld	3.00%	1.70%	1.00%
Citi WGBI ex US >5	36.00%	22.70%	15.00%
Citi USD TBill 3M	0.00%	0.00%	0.00%
Total	100.00%	100.00%	100.00%
Return	6.07%	7.53%	8.32%
Risk	5.32%	7.95%	9.81%
Return / Risk Ratio	1.14	0.95	0.85

Trailing Returns

	5-year	3-year	1-year
Conservative	7.12%	11.15%	1.79%
Global Balance	6.63%	15.28%	5.76%
Growth	6.28%	17.48%	7.93%

In the Next Issue:

-Developments in the global dairy and food staples industries.

-Are Israel's good times ending?

-Will the sun rise again in Japan?

Did you know that ...

97% of all hedge funds underperform the S&P 500?

More than 80% of all mutual funds underperform the S&P500?

75% of all Separately Managed Accounts underperform the S&P 500?

You have a 99% chance of equaling the market's performance using index-based investing?

You have a 47% chance of picking "black" or "red" correctly at Roulette.

Houghton Capital Management's Principals

Peter Judar holds an Master's degree in Industrial Economics from the London School of Economics and Political Science. He earned his undergraduate degree at Skidmore College in Saratoga Springs. He also undertook Doctoral studies at the University of Salzburg, Austria Peter has over 23 years of diversified financial services experience, starting with the Chase Manhattan Bank in New York in 1985 and thereafter holding private banking management positions at Bank Julius Baer and Coutts/Von Ernst Bank.

Since 1991 he has focused on providing financial advice to individual and institutional investors at which time he also participated in the founding of the Julius Baer International Equity Fund, one of the most successful global equity funds to-date. He has spoken at many forums on the benefits of international investing and has been active on various boards including hospitals and children's organizations and the US Navy League. Peter Judar has traveled extensively abroad, is fluent in several languages and has been a Los Angeles resident for 20 years.



Jonathan Gat earned an MBA degree from Universite Libre de Bruxelles, Solvay Business School, which incorporated qualifying study at the London School of Economics and Political Science, and an undergraduate degree from Skidmore College, Saratoga Springs, New York. He entered the financial services industry in 1988 and in 1991 with Bankers Trust Company, worked in their Asset Backed Securities division. In 2005 Jonathan established Prague Street Advisers, an investment advisory firm providing investment advice to individuals.

Mr. Gat has resided overseas and is conversant in several languages. He is a Director of the British American Business Council, a former Director of the California-Israel Chamber of Commerce, and also active in the Japan America Society.

In 2007 he was selected to participate in a leadership development program of the LA Area Chamber of Commerce, Leadership Los Angeles. He is also active on the Education and Workforce Committee of the Chamber.



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