

46.20	22.40	11.91	23.74
42.13	20.41	10.84	21.79
37.97	18.41	9.77	19.84
33.72	16.38	8.71	17.88

Cedarwinds Quarterly

Performance Updates and Market Commentary for Long-Term Investors

Vol. 3 Q3-07 (i)

Asset Class % Returns*

	8/31/07		Annualized Returns**	
	YTD	2006	3 Years	5 Years
Bonds				
Short-Term	3.53	4.78	2.64	2.69
Two-Year	3.36	4.46	2.36	2.85
Five-Year	3.37	4.51	2.66	4.43
Intermediate	3.49	3.89	2.83	4.33
Domestic Stocks				
Large Market	5.16	15.71	10.33	6.06
Large Value	0.19	20.18	16.14	12.37
Small Cap	1.64	16.61	13.40	12.30
Small Value	-1.85	21.55	18.00	18.90
Micro Cap	0.34	16.16	13.27	15.16
Real Estate	-8.45	35.26	26.44	23.35
International Stocks				
Intl Large Value	8.80	34.15	25.82	22.26
Intl Small	9.48	24.88	25.86	26.40
Intl Small Value	9.01	28.39	28.72	30.30
Emg Mkts	21.06	29.17	29.65	25.88
Emg Mkts Value	30.07	37.93	36.04	34.25
Emg Mkts Small	29.07	37.31	30.56	30.87
Continental Small	12.61	45.83	32.46	30.78
Japanese Small	-0.53	-12.07	16.61	20.00
Asia Pacific Small	25.69	39.31	23.14	26.95
UK Small	4.98	45.60	27.81	23.67

Description of DFA Index Funds	TICKER	
Short-Term Bonds	1-Year Fixed Fund	DFIHX
Two-Year Bonds	2-Year Global Fixed Fund	DFGFX
Five-Year Bonds	5-Year Government Fund	DFFGX
Intermediate Bonds	5-Year Global Fixed Fund	DFGBX
Large Market	Large Company Fund	DFLCX
Large Value	US Large Value Fund	DFLVX
Small Cap	Small Cap Fund	DFSTX
Small Value	US Small Value Fund	DFSVX
Micro Cap	US Micro Cap Fund	DFSCX
Real Estate	Real Estate Fund	DFREX
Intl Large Value	International Value Fund	DFIVX
Intl Small	International Small Fund	DFISX
Intl Small Value	International Small Value Fund	DFISV
Emg Mkts	Emerging Markets Fund	DFEMX
Emg Mkts Value	Emerging Markets Value Fund	DFEVX
Emg Mkts Small	Emerging Markets Small Fund	DEMEX
Continental Small	Continental Small Company Fund	DFCSX
Japanese Small	Japanese Small Company Fund	DFJSX
Asia Pacific Small	Asia Pacific Small Company Fund	DFRSX
UK Small	United Kingdom Small Company Fund	DFUKX

*Source: Dimensional Fund Advisors (www.dfaus.com)

The information contained herein is obtained from sources we believe are reliable, but we cannot guarantee its accuracy.

** Calculated based on calendar year results.

Past performance does not guarantee future returns.

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THE RISK - RETURN RELATIONSHIP

Part 5: CAPTAIN AMERICA:

Relevance in the New World Order

"The difficulty lies not so much in developing new ideas as in escaping from the old ones. When the facts change, I change my mind."

John Maynard Keynes -- Economist



Introduction

At this juncture in our series on risk-return relationships, it is appropriate to refresh on the importance of international asset classes in the creation of diversified investment portfolios. In this edition we will examine some of the macro forces of change supporting our global diversification strategy. This topic is particularly relevant in view of the recent volatility experienced across all global asset classes. Our next update will address on a more micro level how global asset class correlations impact portfolio structure and investment performance. (For added context, readers may want to refer to the edition of *Cedarwinds Quarterly* published last year, "Indexing the Global Village," along with a new posting, "Perspectives on Recent Market Volatility.")

CAPTAIN AMERICA: R.I.P.?

We begin our analysis with an allegorical view of the recent "death" of Marvel Comics' hero, Captain America. Earlier this year, after nearly 60 years in print, Marvel killed off Steve Rogers, a.k.a. Captain America, one of its most beloved and famous superheroes. Captain America first appeared in 1941, just as the United States entered World War II. Born before the Great Depression in a very different America, he was a symbol of American strength and resolve in fighting the Axis powers, and later, communism. Captain America represented patriotism, omnipotence, idealism and innocence. According to the publisher, the storyline of Cap's death was intentionally written to symbolize current real-life issues like the decline in U.S. global influence, the war on terror, and the 9/11 attacks. The writers apparently felt he hadn't been living in the modern world and "the world does change."

Continued on back . . .

In many respects, the demise of the iconic superhero, Captain America, symbolizes what has been happening over recent years to this country's previously dominant position in the global investment marketplace. The U.S. evolved from being what was essentially an emerging market country at the end of World War II into an economic juggernaut in the 1960's through the 1990's—the envy of the free world and a shining beacon of the power of capitalism.

However, the world *does* change and our leadership role in the global investment community has not only changed, it has diminished. Ironically, it is our capitalistic system—the same model adopted by many other countries—that has set the course for the profound changes that have resulted in our declining influence in world markets. Against this gloomy backdrop, one has to wonder, is Captain America really dead? Will the U.S. be back? We think the answer can be “yes,” but it will require nothing less than a complete metamorphosis of how we look at the world.

Inconvenient Truths

While the United States will always have a strong position in the global economy, analysts and investors are starting to step back and understand how our place in the world is changing. Here are some facts to ponder:

- The United States represents only about 22% of the world's current gross domestic product (GDP) and 45% of global-equity capitalization. Although we continue to lead the world in total output of goods and services, the rest of the world is catching up. Global GDP growth has exceeded U.S. GDP growth in recent years and the spread is widening. In 2006 the global economy grew at a rate of 5.4% compared to 2.9% for the U.S.
- Productivity growth in the U.S. is also falling behind. Manufacturing productivity and labor cost trends in the U.S. grew at a rate of 3.3% in 2005, placing it ninth among the 16 economies measured by the Bureau of Labor Statistics. High productivity is one of the best leading indicators of real, non-inflationary, economic growth, especially when it is invested in infrastructure and other building blocks of a strong, local economy.
- Over the past year, a staggering 60% of the world's broad money supply growth has flowed from emerging economies. The growth in China's money supply has quickened to 20% over the past year. In Russia, money supply has gone up by a striking 51%; in India, it is up by 24%. Indeed, the broad money supply in emerging countries has increased by an average of 21% over the past year, almost three times as fast as it has in the developed world. What's more, China and India have real interest rates among the world's lowest, even though they have the fastest growing economies.
- A decade or so ago, monetary growth in emerging economies was of little concern to the central banks of the developed world. But today, the emerging economies play a larger role in the world economy and cross-border financial flows are much bigger. In fact, the world's two most important central banks, the Fed (Federal Reserve) and the ECB (European Central Bank), have not been the main sources of global monetary liquidity. Looking forward, the policies of the Peoples Bank of China and the Bank of Russia are likely to have an increasing impact on developed economies as capital controls are reduced and markets become more integrated. This becomes more alarming when one considers that, unlike the Fed and the ECB, central banks in emerging economies are not independent, and thus free to set interest rates in the best long-term interests of the economy. They are still firmly under the control of politicians. The days when central bank watchers could just focus on the Fed and perhaps the ECB in order to assess global monetary conditions are over. And as financial markets become ever more linked, analysts will need to pay more attention to central banks in the emerging world.
- Emerging markets appear especially promising from a macroeconomic point of view. According to the World Bank, emerging markets grew faster over the last decade (1995-2005) than in the two previous decades and faster than high-income countries. World output in 2005 amounted to about \$61 trillion, 45% more than in 1995. The share of emerging markets in global output increased from 39% to 46%. This acceleration in growth was attributed to better functioning internal markets, further integration into world markets, and rising demand for many commodities. As these developing countries work to reduce deficits, build reserves, and establish more cautious monetary and financial policies, they are becoming less vulnerable to economic shocks.

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Embracing the New World Order

Despite the declining leadership position of the U.S., the forces of globalization are having a remarkably positive effect on the world's economies, creating a seismic shift in the international investing landscape. A recent article in Barron's cited two critical developments fueling the new world order. First, there are 3.5 billion people from Eastern Europe to the Pacific and from the Indian Ocean to the Arctic that were living under socialism or communism as recently as a decade ago, where it was not possible to trade and not possible for an entrepreneur to get rich—and they have been transformed. More than half the world population is now “in play” and suddenly, world competition is moving to center stage. Second, there has been a total collapse in the cost of communication and computation. Time and distance in communication have been eliminated through the Internet and fiber optics. Communication is instantaneous and virtually costless, and, as a result, you can run businesses all over the world, headquarters positioned anywhere on the globe.

This means the whole global economy has to be transformed. There are not only huge incentives to do this, there is a necessity to do this. This transformation creates potential competitive advantage not only to the big international companies, but also to the small, local ones that have an international point of view. Importantly, these two major changes are happening totally outside of the financial markets. They have nothing to do with derivatives, nothing to do with home-equity loans and nothing to do with private equity hedge funds. It is truly difficult to imagine a world where governments that have opened their markets close them again to foreign investment or where progressive economic reforms reverse course. These changes are happening all over the world, and there's no way to stop it, unless people and their governments lose faith in the new theology of capitalism—a highly unlikely scenario.

Opportunity Drivers

For investors, global growth and the integration of financial markets have exponentially expanded investment opportunities. In countries around the world, political and economic reforms, open markets, burgeoning international trade, and other indicators of globalization have attracted foreign investment and allowed capitalism to take root and thrive. In addition, many governments have successfully leveraged new infusions of capital and taken reforms to the next level by improving infrastructure, banking systems, financial markets, and education systems. These changes have helped lay the groundwork for developing nations and smaller companies to compete on the world stage.

Some of the more dynamic and far-reaching elements driving these global changes include:

- **Political and economic reforms**—Developing countries that have embraced globalization have almost universally undertaken reforms to open their doors to economic growth and trade. Greater access to local banking and financial systems has also improved living standards, helping to promote participation in a countries and markets by larger swaths of society.
- **Young, educated workforces**—Many developing nations, particularly in Asia, are home to large populations of young people. This demographic signifies a growing supply of workers for decades to come, a fact that may help keep wages in those countries competitive relative to the U.S. and Europe. This will be a powerful magnet for foreign investment.
- **Foreign direct investment**—Foreign, direct investment in many developing countries has surged in recent years. It is no coincidence that increasing investment in these areas has fueled the manufacturing growth, commercial competition, production capacity, infrastructure development, and exports. As economies around the world expand, increased demands are made of basic infrastructure such as roads, bridges, airports, mass transit systems, communications networks and power generation facilities.
- **Agriculture**—The shift from state-dominated economies to market-driven economies has improved the economic fortunes of many countries throughout Asia and Latin America. Greater economic strength has helped to drive up household incomes and expectations for higher quality, more nutritious food, including more protein from meat sources. Supply and demand forces will generate greater international trading relationships in order to feed a growing world population.
- **Improving credit ratings**—The effects of government reforms—more stable financial markets and increased foreign investment—has improved the credit quality of emerging market debt.
- **Ongoing regulatory reforms**—Growth in new businesses has been stimulated by a regulatory environment that makes it easier to start a business and easier to adjust a business to changing market conditions and opportunities, so that investment capital can be employed in the most productive areas possible.
- **More stable banking and financial systems**—Part of governmental and political reform is the improved health and stability of financial markets. Governments that recognize that a stable financial system, open markets, and few barriers to trade are keys to growing their economies and have fostered environments that are conducive to competition. These reforms are often a boon to small companies, resulting from an open and welcoming system, greater data access and the ability to take advantage of the many market opportunities just like their larger, more established counterparts.

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- **IPO activity**—One indication of an increasingly positive environment for small-cap companies is the recent rise in initial public offerings in various markets across the globe.
- **Commercial real estate growth**—Many countries have watched their real estate markets expand and grow in value as a result of economic growth and infusions of foreign capital. The combination of a strengthening real estate market and continued foreign interest has led many governments to follow the lead of the U.S. and enact REIT legislation.
- **Lifestyle spending**—Global economic growth has produced an emerging middle class in developing markets and an expanding universe of affluent individuals in developed ones, creating greater options for investors willing to go abroad to seek the most compelling investments. Additionally, greater spending on travel, recreation, and leisure goods results from global expansion.
- **Increased global perspective**—The fact that more people are traveling outside the United States means Americans are gaining a broader perspective of the world and our place in it. Where international investing was once done on a small scale for diversification purposes, it is now reflecting the larger trend toward globalization and the desire to take advantage of once-in-a-lifetime opportunities outside our home country. As world markets become better regulated, more transparent, and increasingly open to foreign investors, global investment opportunities are available to all.

What It All Means

Global is everywhere today—global warming, global infrastructure, global supply chain management, global liquidity, global credit, global terrorism—both the good and the bad. From this perspective, we take a decidedly optimistic view of the potential for the United States in terms of the constructive impact we can have in influencing the development of the new world order.

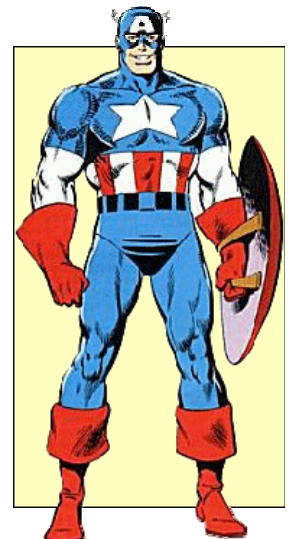
In the best-selling book, *The World is Flat*, (we recommend it highly) the argument is made that the U.S. as a whole will benefit more by sticking to the general principles of free trade, as it always has, than by trying to erect walls, which will only provoke others to do the same, impoverishing us all. The case is made that we must continue to develop knowledge workers who are able to produce idea-based goods that can be sold globally and who are able to fill the knowledge jobs that will be created. The implication is that while there may be a limit to the number of goods factory jobs in the world, there is no limit to the number of idea-generated jobs.

As we see it, the future economic vitality of the U.S. will be defined by how well we compete for human capital in an increasingly global marketplace. Our view is that the developed world will be able to grow economically by continually driving innovation, but it won't corner the market on innovation. For the global economy to grow, the young population of the developing world—perhaps the most valuable asset—will not just be the hands that produce goods and pocketbooks that purchase them, but the minds that produce innovative ideas and products as well. The prodigious talents in the developing world must be fostered through education because historically, the countries that invest the most in educating their populations have the most successful economies. This is the fundamental challenge facing the U.S. and other countries as we all try to stake a claim in the evolving global economy.

Summary

From an investment management perspective, we feel the opportunities that lie ahead are legion and we eagerly embrace the challenges of competing in the new world order. Our view is that we are in the initial stages of what can be best described as a global investment renaissance. We believe that global investing is rapidly evolving as the new core portfolio strategy versus the traditional U.S.-centric philosophy. The period ahead will be challenging, characterized by vastly increased complexity, uncertainty, volatility and risk. But it will also provide great investment opportunities if strategies are thoughtfully developed and risk is managed effectively. In the final analysis, the great thing about globalization is that it holds the promise for raising the standard of living for everyone and to change all of humanity in profoundly positive ways, including improving the chances for world peace.

No, Captain America is not dead, he is just changing to be more relevant on the world stage. Embracing the new world order will make the U.S. stand prouder and tougher and wiser. While real risks remain, the paradigm shift in international markets, more than ever before, make them essential portfolio components for all long-term investors. The key question facing investors is how to *appropriately* position various global asset classes as part of a broadly diversified risk management strategy. The next installment of [CEDARWINDS QUARTERLY](#) will address how our blend of different international asset classes is designed to take advantage of the transformation occurring in the world markets in a highly disciplined and risk-effective manner.



"Embracing the new world order will make the U.S. stand prouder and tougher and wiser."