MV Capital Management Thought Content Series: Markets in Crisis

Bubbles in Wonderland

August 20, 2009

Recession-Plagued Nation Demands New Bubble to Invest In
-The Onion, 14 July 2008

The headline in the satirical newspaper *The Onion* was funny when it came out just a bit over a year ago: today it is funnier still, though admittedly in a gallows humor sort of way more than anything else. We got our comeuppance from bubblemania, and then some, during the dismal months of autumn 2008. Learned a good lesson – or did we? The global investing class ran on a 12-year bubblegum high from 1995 to 2007, notwithstanding the spasmodic (and relatively brief) withdrawal pangs of 2000-2002. Do the world's movers and shakers of capital even remember what it was like to invest in markets absent the relentlessly euphoric techno-rave rhythms of bubblemania? Can they relearn that lost art?

The thing about good satire is that it manages to strike a true chord amidst the humor. You come away saying – hey, that was funny…hmmm, and they make a pretty good point, too. Today, after one of the most dismal episodes in U.S. equity market history, we are struck by how that *Onion* humor has not lost its piquant edge. These sultry dog days around the Chesapeake watershed region make it almost seem as if we drifted off to sleep, time-traveled and woke up again three years ago, in August 2006. Back then the market was steadily churning upwards on the back of a junk rally – when stocks with the shabbiest earnings metrics soared far ahead of their buttoned-down blue-chip counterparts. This year, the Russell Midcap Growth Index is up a giddy 27.9% (as of August 14) while the staid Russell Top 50 Index of stalwart corporate giants plods along at 8.6%. Emerging markets returns are even more eye-popping: the MSCI BRIC and Latin America indices are both up more than 60% for the year. But maybe the most stunning statistic of all comes from the bond market – that traditional safe haven investment backwater – where the Merrill Lynch CCC-Rated Bond Index is up 71.5% for the year. That's right – the stuff that no pension plan will touch, the asset against which institutional investment policy statements immunize themselves as if averting an invasion of the bubonic plague – *that* is apparently the place to be in 2009.

Welcome to Wonderland. In this looking-glass world the 7-10 year Treasury bond index provides more stomach-churning gag reflexes than a Coney Island hot dog-eating contest, and the movements of whole asset classes seem to burst into and out of existence faster than quantum particle-antiparticle pairs. It seems like everything has changed – everything, that is, except for the behavior of market participants and the Friday night smackdown entertainers otherwise known as the mainstream financial media. The capital markets playing field itself may have tunneled into some alternative risk-return universe, but the players and their chroniclers have stayed mentally in 2006.

Nowhere is this more evident than at the pinnacle of our financial Valhalla. Goldman Sachs, the gold standard of the brand, made news for two notable events this summer: first, paying back its debt to the U.S. government in time to announce that its incentive compensation plans for 2009 will make those pre-crash days look positively dowdy; and second, being at the forefront of Wall Street's latest innovation to suck value from the real economy – high speed trading, a strategy whose single purpose is to make money by executing securities trades just a few nanoseconds faster than the rest of the market can react to events.

Think of high speed trading as being not only a bad idea, but a really bad idea even in the context of other recently notorious bad ideas like leveraged-to-the-hilt collateralized debt obligations and credit default swaps. At least the original DNA of those toxic assets had the imprimatur of a defensible, logical argument about the virtues of securitized cash flows and parceling of risk. In 2000 David Li, a quantitative expert at JPMorganChase, submitted a paper to the *Journal of Fixed Income Securities* based

around an arcane model that suggested using credit default swaps as a proxy for pricing risk in the mortgage market. The model contained plenty of caveats and dubious statistical shortcuts that even the author, himself, noted, but that didn't stop the entire population of Wall Street from piling onto this apparent golden goose and eventually ginning up the CDS market to a stratospheric value of $62 trillion by 2007. The Wall Street crowd couldn't help themselves from turning a pretty-good-and-reasonably-profitable contained venture into a really-bad-and-obscenely-profitable go-go bubble. There was too much money to be made, and the rest of the world – self-dealing rating agencies, fatuous media pundits, and eventually your next door neighbor with a Florida condo-flipping moonlighting gig – went along for the ride. As with all bubbles, of course, the Wall Street gang bailed out before your neighbor could.

With high speed trading there is not even the genesis of a good idea or a pretext from its backers that it has some lofty purpose to fulfill other than front-running the rest of the market to earn outsize profits (all the more necessary to justify those outsize bonuses that are back in the mix). What the market needs now is not *more* speed – rather, it needs a sharp-eyed audit of all the prototypical high speed trading schemes that went on at the hedge funds and elsewhere during the last bubble. Massive swells of near-instantaneous cash pushed a whole variety of markets from crude oil futures to frontier market small-cap stocks into bubble territory. What Goldman and its ilk are saying now is: hey, not only can we keep on doing that, but we now have the technology to *even profit a few microseconds ahead of those hedge fund swells.* That, in a nutshell, is the promise of high speed trading and no doubt those top-tier traders who figure it out best (and if history serves as any example lots of them exist on the payrolls of Goldman and JP Morgan, the last of the bulge bracket pantheon) will be prominent in the receiving line for all those obscene short-term bonus payouts we are assured to be seeing this Christmas.

It's not 2006 any longer. At some point, we have to believe, the new state of things is going to catch up even with the high priests of Wall Street. In the meantime, it seems that bubble addiction is a hard vice to overcome – especially for those who have grown used to the idea that there are no negative repercussions from this particular addiction. As for us, we think it's high time for the denizens of investment markets to re-learn that old art of making profits in the absence of bubbles. Patience and discipline may be boring, fundamentals may be quaint, but they mean as much to us today as ever, and we're sticking to that recipe.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

MVCM 2009 0020
DOFU: August 2009

MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. Securities offered through Purshe Kaplan Sterling Investments, Inc., headquartered at 18 Corporate Woods Blvd., Albany, NY 12211, Securities Dealer, Member FINRA/SIPC. Insurance offered through MV Financial Group, Inc. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

This email and any attachments are intended only for the use of the individual addressed and may contain privileged and confidential information that is exempt from disclosure. If you are not the intended recipient, you are hereby notified that dissemination, distribution, retransmission or copying of this communication is prohibited. If you have received this communication in error, please destroy it and notify us immediately.