MV Capital Management Thought Content Series
Markets in Transition

The Path to Tomorrow
September 21, 2009

Twelve months ago the world was falling apart. In September 2008 Lehman Brothers collapsed and it seemed that the rest of the financial world was following close behind: AIG, Merrill Lynch and then the entire swathe of what had once been known as the "money center" banks: Citigroup, Bank of America and all the rest, right to the edge of the event horizon. At the beginning of 2009 there was not a clear answer to the question "is the entire global economy going to collapse?" When Citigroup traded for $1 per share in early March the answer from the collective wisdom of the market seemed to be: looks like that's exactly what is going to happen. And then – back from the edge of the abyss.

We began our "Markets in Crisis" series last fall and it is with some degree of relief that we are now consigning that compendium to the archives and beginning a new one. So welcome to the maiden issue of our new Thought Content Series, entitled "Markets in Transition". This series will pick up where "Markets in Crisis" left off: the worst of all possible outcomes has not happened, but the world is a very different place today on many, many levels. As always, our commentaries in this series will look at things that are happening in the world and try to distill some sense out of them to think about what the implications may be for the short, medium and long term performance of global investment markets.

The markets are in transition. There is no single deterministic path we can follow to whatever it is that happens next. We are in the middle of a Gap Market. As we infer from earlier Gap Markets, the forces to power the next period of sustainable growth are most likely at work now. Which of them are going to become the rocket fuel that puts economies and markets on a macro growth trend? If globalization and deregulation powered the Great Growth Market of 1982-2000 what will their equivalents be? Years from now, what will the chattering classes be saying about the beginning of the second decade of the 21st century? What will be second nature to them the way that the Internet is now second nature to us?

The other day we came across an interesting collection of market commentaries from the end of the first decade of the 20th century. These were the sunset years of a long, magnificent period of globalization that ran from about 1870 until the outbreak of the First World War in 1914. At the time Britannia ruled the waves of international finance. The world was on a gold standard and the British pound sterling was the reserve currency for anyone transacting in this global economy. Yet by this time Britain was not growing as fast as some other countries in the world. The commentators of the day were wondering which of the world's emerging markets – circa 1909 – were going to dominate the next economic paradigm. The United States, a fast-growing industrial power, was considered by many to be the odds-on favorite.

But so was Argentina. Since we all know how that turned out this may seem somewhat amusing. It therefore helps, sometimes, to go back and actually read the source documents of the day rather than somebody's history of the 20th century, written with the benefit of hindsight. Of course it seems obvious to us – the U.S. has been the world's economic superpower for decades now. But if you put yourself into a 1909 framework and work with the data points that were available at the time you can see how the case for Argentina could be made as well. You can also see the perils of making a bet about the future. No matter how brilliant you are, sometimes you're going to get it wrong. Even Einstein got it wrong sometimes (more about that in one of our forthcoming pieces).

All this is very relevant to us because much of the growth that is taking place in the world today is taking place somewhere else in the world. Our job is a tricky one. On the one hand we want to piece together the data points and figure out how best to position our portfolios to benefit from long-term structural changes that are taking place in the global economy. On the other hand we don't want to fall into the crystal ball trap – convincing ourselves that some or other scenario is the one most likely to happen and making all our allocation and exposure decisions on that basis.

Here's where the phrase "Black Swan" comes into play. You have heard us use this phrase before, and it appears as an iconic image in our periodic Market Outlook commentaries. Now we're going to explain why this phrase figures so prominently in our thinking. Several hundred years ago no European had ever encountered a swan that was not white. If there had been computer programmers back then they would have expressed this as "if [swan], then [white]". All the data points said with 100% probability that swans were white. Then a seafaring expedition returned from Australia and brought back some indigenous species from Down Under including…yes, a black swan. Suddenly one new data point renders every other data point meaningless.

Black swans are what we call "low probability events". The main thing to know about low probability events is that they are never the most likely thing that is going to happen. But when they *do* happen it doesn't matter that they were not *likely* to happen. Eighteen months ago, even though we were already in the middle of a recession, the scenario that "all financial institutions collapse and have to be bailed out by the U.S. government" was a Black Swan – it was a low probability event. If you had taken a bet in July 2008 on that outcome happening in September-October you had more than a 98% chance of being wrong, using the traditional tools of statistics and probability analysis. But that's cold comfort to anyone who has to live through the event. Of course, Black Swans aren't all negative – they can surprise on the upside too. The world could bounce out of recession and the U.S. economy could resume the pace of the late 1990s. That's a low probability scenario. But could it happen? Of course it could – and so could a near-infinite number of other possible outcomes.

So we clearly have our hands full as we try to figure out where these markets in transition are heading. We will never tell you that we have the definitive answer. We don't have crystal balls. But we are thinking about a great many things every day, and we look forward to sharing these thoughts with you.

With warm regards,

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MVCM 2009 0022
DOFU: September 2009

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