MV Capital Management E-Update

What Does It All Mean?
April 12, 2006

You frequently hear from me that the short term is unknowable. In an earlier e-update this year we noted that the markets were punished in the final week of 2005 when investors took note of the (slightly) inverted yield curve. In the past this rare occurrence had been a predictor of all but one recession since 1950. However, outgoing Fed chairman Alan Greenspan noted at the time that the increased complexity of the financial markets has likely weakened the predictive power of the shape of the yield curve.

Three months hence the markets have put in one of the strongest quarters in recent years, while the yield curve has barely changed its shape. New Fed chairman Ben Bernanke expanded on his predecessor's views in a speech to the Economic Club of New York on March 20, noting that the factors affecting the shape of the yield curve could derive from four or five primary drivers. These range from a general decline in demand for a real interest rate premium at the long end, to the actions of foreign banks in the currency markets, to decreased volatility expectations. Which of these is the right answer? Bernanke, who has made a name for himself studying such phenomena, essentially said: we have no idea.

Recession, though, appears to have been far from the minds of investors as nearly all major asset classes saw impressive first quarter gains. Among the broader indices, the S&P 500 and the Dow Jones Industrial Average finished within a nose of each other at 4.21% and 4.25% respectively. The NASDAQ returned just over 6%, indicating that technology is back in favor. Small cap stocks extended their run in relation to large caps. The Russell 2000 index of small caps returned a robust 13.94% as compared to 4.49% by the large cap Russell 1000. Real estate surged ahead into the headwind of mounting evidence of a slowdown in property markets, though some of the double-digit gains of the first quarter have been surrendered in the second quarter's first week. International exposure was again rewarded with the MSCI EAFE index returning 9.47%.

What does this all mean? Our thinking follows both a strategic and a tactical orientation. Overall, we continue to see evidence of sustained economic growth across the developed markets of the US, Europe and Japan with central bank policies in these markets very much in line. Long run this is generally good for the equity markets despite short-term interest rate concerns, particularly as inflation for the time being appears contained and the markets have shown resilience in the face of various X-factors over the past year.

The bond markets are proving to be vexing for many investors. The Lehman US Aggregate Bond Index lost 0.64% for the first quarter, as the Fed continued its rate hike program with two 25 basis points increases in the Fed funds target while long term yields moved slightly higher relative to short terms. In our opinion the smartest strategy for fixed income in this environment is to stay flexible, and this means generally a mix of short-term exposure and hedging strategies. We believe the Fed will conclude its rate hikes by the end of the first half

of the year, which would stabilize the short end of the curve. Being locked into longer maturities appears risky to us given the present structure of the Treasury curve and the relatively narrow spreads between Treasuries and other debt instruments.

At the tactical level, the current pace of small cap gains is likely to taper off relative to large caps. Many cash-rich, low-debt mega cap stocks continue to trade at sizable discounts to fundamental value. Mean reversion argues that at some point investors will move in to capture these discounts in anticipation of historical trends reasserting themselves. Of course, we also have to pay attention to underlying structural factors that may influence these historical trends in new directions.

Returning to the question we posed in this letter above: what does it all mean? In the short term, we agree with Messrs. Greenspan and Bernanke – we cannot know with any certainty the outcome of interplay between complex factors. Past performance really is a poor indicator of future results. In the long run, though, we believe patience and discipline are the most promising ingredients in a recipe for success. The only thing we can promise is that we will stay true to these values in the interests of helping our clients win.

With warm personal regards,

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