MV Capital Management E-Update

When Fear Takes Over

January 18, 2008

On October 9, 2002 the S&P 500 index hit 777, its low point for the 2000-2002 bear market. That was 49% off the high of 1527 reached on March 24, 2000. The technical definition of a bear market on Wall Street is when stocks fall 20% or more from their previous high point. The week that is ending today (January 18) looks set to be one of the worst on record since those first three dismal years of this decade. As of its close on January 17 the S&P 500 was at 1333, just about 15% off the previous (and S&P record) high of 1565 set on – of all auspicious dates – October 9, 2007. Given the present climate in the market – driven largely by the emotion of fear rather than any specific news – the 20% bear market threshold could be approaching in the next few trading days.

There are many differences between the market environment of 2002 and that of today. One of the most important, though, is simply the marked difference in valuation levels. The market appreciated 101% over the five year period from 10/9/02 to 10/9/07. But at that 2002 low point the S&P 500's trailing 12 month P/E ratio was 25.3x. On December 31, 2007 it was 16.9x. That's a significant difference. Today the stock market is not expensive by historical standards. The world really doesn't look much different today than it did in December, or even in October for that matter when the markets reached their record highs. The housing market is in a slump now, like it was then. Subprime loan disclosures from large global financial institutions dribble out in press releases every few days, just like then. The economy is slow, but nobody can say for sure if it's in or near a recession yet. Inflation is higher than people would like but not running out of control.

Just like then. So why is the market in such turmoil?

You've heard it from us before – in the short term the market is driven by fear and greed. Nobody wants to be left out of the party during a go-go run like the end of the 1990s, and nobody wants to be left in the room when everyone else has run out the emergency exit and turned the lights off. In the financial markets emotions matter, and they play a big part in these wild moves that seem to have little to do with underlying fundamentals.

At MVCM we are also concerned – but less about the doom and gloom gyrations around us in the short term trading market and more about the longer term outlook. All of you will be receiving our 2008 Market Outlook in the next few days along with your end of year reports. We strongly advise you to read through this document in order to see how we assess the market and what types of actions we are taking in anticipation of the year to come and for that matter several years ahead. We have characterized this year as one in which the key objective is to simply not lose money more than it is about outperforming some benchmark – after all if the benchmark is down then saying "we were down less than the benchmark" offers scant comfort.

Despite the turmoil of the past few days we think it is far too early to say that a negative return is the most likely outcome for the year. We think the main story is volatility. In other words it is not so much about establishing a mean expected return as it is about how much variance there is in that mean estimate. You may hear an analyst say, for example: "our estimated expected return for the stock market in 2008 is x%". What does this mean? Probably, it means that the analyst had established a number of different scenarios based on alternative economic and related

conditions, assigned probabilities to each outcome based on some methodology, and then arrived at the expected outcome of x% as a probability-weighted average of the different scenarios. That's how it usually works – certainly that is something that we at MVCM do on a regular basis).

The important consideration here is how wildly those scenarios differ from each other. If Scenarios A, B, C and D all contribute to that weighted-average expectation then how wildly different are, for example, outcomes A and D? Is the analyst's best case scenario 15% and worst case 10%? Or is the best case 15% and the worst case -25%? How much these alternative outcomes vary from the mean expectation is what produces *standard deviation* – the statistical measure we commonly use to express risk. A higher standard deviation increases the likelihood that the actual outcome will differ considerably from the expected outcome.

That's important because all across the country – including at 4520 East West Highway – analysts are running 2008 scenarios with a larger than average variance in possible outcomes. That means we have to be defensive in a way that anticipates a sustained downturn but also doesn't leave us high and dry if the market does surprise on the upside. Sometimes it's easy to forget that risk as we define it in the investment industry can result in outsized gains as well as outsized losses.

We are in our kayaks, the waters around us are choppy but we are already looking downstream to the next bend. Along the way we will be sharing our thoughts and strategies with you. May the year bring peace, health and happiness to each and every one of you.

With warm regards,

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