MV Capital Management E-Update

Road to Where?

March 22, 2007

Where are we going? The multitudes are asking the question with some urgency these days. Indeed, the topography of our investment map looks a bit rocky. Last week the S&P 500 closed just about 5% off its 52-week high set back in February. So far this week the trend has been mostly bullish, but investors still seem to be tiptoeing around the question as to where things are headed from here. How bad is it and how bad could it get?

At the lowest point so far this year, back on March 5, the reversal in the major equity markets has not yet approached the 10% level that technically constitutes a correction. Before things started going wobbly back in February the markets had been on an unambiguous uptrend since June of last year, trading above their 50-day moving averages for 148 straight days in the case of the Dow Jones Industrial Average. One could quite easily opine that the market was simply due for a pause after this period of impressive gains.

The question is whether there is more to it than that. Prior to late February the CW was outdoing itself on a daily basis with pronouncements of utter perfection in the "Goldilocks" market. The cheerleaders made two compelling arguments: (a) the market has appeared able to digest any data, on inflation or earnings or geopolitics or anything else, and move onto a new high without missing a beat; and (b) valuations seemed to be fairly priced.

It's pretty hard to argue with either of these propositions. Corporate earnings, which account for the "E" of the P/E value measure, have been on a double-digit tear since 2003. The overall picture the economic numbers appeared to paint was moderating growth with inflation held in check (the "not too cold, not too hot" Goldilocks mantra), and the main thing keeping a lid on even more buying exuberance was the decreasing likelihood of a Fed rate cut.

In one of our e-Updates earlier this year we observed that what concerned us more than the data supporting the Goldilocks view was the *attendant low level of risk* in the market. Bear in mind that the way we measure risk in investment markets is volatility – the extent to which a time series of returns deviates from its average, for example, or the range between the market high and low points during a day of trading. By these measures risk has come back with a vengeance – we had two days last week where prices on the S&P 500 swung by two percent or so during intraday trading. And we think this volatility is here to stay for awhile.

Back in February leading global bank HSBC announced it had badly underestimated reality in making provisions for bad debt – mostly delinquencies and defaults among so-called subprime borrowers. The woes of other bankers active in this space, like mortgage company New Century, followed suit and the market quickly decided that here was a real actualizing risk. Overreaction followed with investors hitting their sell buttons for anything that – however vaguely – resembled a subprime lending company. The catch-all phrase for explaining the reversal – the facile "market was down today because of X" pronouncement so beloved of the TV talking heads – went from Shanghai to subprime in the blink of an eye.

Not to be too glib about it, there is a fundamental risk here. What happens in the subprime market, which includes a significant proportion of first-time home buyers, feeds up into higher strata of the housing market. Subprime loans have been a major enabler during the real estate

bull market of the past decade. The fear being voiced by the doomsayers now is that this risk is viral rather than containable – that the problem is going to spread well beyond the treatable remedy of a comeuppance for greedy mortgage lenders and their starry-eyed clients who really couldn't afford that four-bathroom Tudor spread to begin with.

Another dolorous chorus chants of dangers lurking in the mortgage-backed securities markets. This is a somewhat lesser understood risk. When a homebuyer takes out a mortgage with a lending company, the lender typically sells that mortgage onto another finance company that pools a large number of such mortgages together and sells interests in these pools to large investment banks. The Wall Street propeller heads slice and dice the mortgage pools into various types of securities – usually connoted by some three letter acronym like MBO (mortgage-backed obligation) or CDS (credit default swap) – and then sell the different slices to investors with various risk tolerances. In theory the riskiest slices are prudently isolated among investors with appropriate risk tolerances – but the fact is that these are relatively new products that have never seen the downside of an economic cycle. Additionally leverage in this market is very high, which will compound the pain factor if risks turn out to be higher than calculated.

A viral subprime lending market or a liquidity meltdown in mortgage-backed securities can both be genuine risks. However we don't see either as the most high-probability outcome. We noted at the beginning of this year that the housing market may continue to drag on overall economic growth and believe this is coming to pass. But we do not see meaningful evidence at this point that it is spilling over into our "perfect storm" scenario whereby isolated problems metastasize into consumer spending and other macro woes. Volatility is going to have investors searching for higher quality and lower correlated assets. We're comfortable with where we are in that sense. But as we have said several times this year already, we are not so comfortable as to sit back and take our eye off the rapids ahead. You can rest assured that we have a hawk-like fixation on events and an obsession for making decisions that we believe will help you win.

With warm regards,

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MVCM 2007 0005
DOFU: March 2007

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