MV Capital Management E-Update

Bulls, Bears and Opportunities

May 12, 2008

Investors buy stocks because they think they will outperform bonds over the long term despite higher short-term volatility. That's certainly been true for the past 25 years or so. From August 1982, when the stock markets hit their low points for that year, through April 2008 the annual average total return on the S&P 500 stock index was 13.4% versus 9.1% for the Lehman US Aggregate bond index. In a bull market environment investors can park money in the stock market, go away and come back later to enjoy their gains.

Our present decade reminds us that it's not always Easy Street, though. In the upside-down world of January 2000 – April 2008 the S&P 500 has eked out a measly 0.97% average annual total return (all of that being dividends, with no capital appreciation) while bonds have turned in a relatively cheerier 6.5%. A not insignificant chorus of market observers believes the great bull market of 1982, the longest since the dawn of the 20th century, is over. Is it? The Dow Jones Industrial Average topped out at 11,722 in early 2000 before the tech bubble collapse. It got back to that previous high in fall of 2006 and has stayed above there for most of the time since then – affirming the bull, right? Not so fast. Two other popular broader-market indices, the S&P 500 and the Nasdaq Composite, both still trade below their 2000 highs (Nasdaq is about half of the value of its giddy peak in March 2000). If this is a bull market it is a "yes…but" bull market, a bull market with an asterisk. It certainly doesn't feel like a bull market.

From our vantage point in the kayaks the challenges are many indeed. Our primary goal is to try and understand where the opportunities are. If indeed we are seven years into a bear trend (which may or may not be the case but is certainly plausible) then we look to instructive lessons from financial markets history showing that in every bear market there are potential ways to make money. They are trickier than bull market strategies (which after all can consist of nothing but buying an index fund and retiring to the hammock for a long nap), but possible nonetheless.

Over the course of the 20th century there were three prolonged bear market periods. The Dow Jones Industrial Average broke through 100 points for the first time at the beginning of 1906. Perhaps the tragic San Francisco earthquake of April that year was an omen of bad things to come in the markets. After a financial panic in 1907, a world war and a revolution in Russia among other major world events over the ensuing 17 years, the Dow closed out the year 1923 just a bit under...100 points. Bad news for the index investor prototypes of that day. The next bear market was even worse, of course. The Dow reached a high of 381 in 1929, a level it was not to see again until 1954. Then, in the Swinging Sixties the Dow flirted with 1000 several times in the early months of 1966. The index broke through that level for the long term only in early 1983, some 17 years later.

Currently the strategic positioning of our portfolios is oriented towards protection against downside risk rather than aggressively pushing out the risk frontier for enhanced upside capture. That strategy reflects our view that negative economic fundamentals like high inflation, tepid consumer spending and discombobulated lending markets are persistent factors that may be around for awhile.

However that does not mean that we see all bad things, all the time. Quite the contrary – one of the instructive lessons of previous bear markets is that shorter-term periods within the longer

trend offer significant opportunity. As we noted above the period from 1906 – 1923 was pretty glum in the aggregate. The market fell sharply during the financial panic of 1907, but towards the end of that year investors concluded the market had oversold and got back in, driving the Dow from a low point of just over 50 in November '07 to back up around 100 by the second half of 1909. Then, after falling again in 1910 to a low of 75 in late July the market rallied back up to 94 by the fall of 1912.

The really good news is that today we are armed with the arsenal of opportunities that exist in the global capital marketplace of 2008, not 1908. For example we may sense that equity markets are due for a shorter-term uptrend but remain nervous about the prospect for US stock markets and the financial sector in particular. So we look for thematic opportunities in global equity markets like emerging Asia Pacific or Latin America. The US high yield bond market is still dodgy but we like international sovereign debt issues from countries with massive foreign reserve cushions. We are nervous about the soaring price of crude oil but believe there may be longer-term value in natural gas commodity futures. In addition to seeking higher performance returns from these allocations we are looking to benefit from the low-correlation properties of some of these exposures. Low correlation and downside protection go hand in hand.

There are times when it makes sense to apply strategies that have worked in the recent past to present conditions, and there are other times when it makes very little sense at all. We very much believe we are in one of the latter times. We cannot be content with looking at pictures of asset relationships that prevailed during the 1980s and the 1990s and extrapolate them to our forward-looking models. We have to look at 1908, at 1938 and 1968 – but at the same time remember that we live in 2008 and think hard about how the realities of our economic, geopolitical and socio-cultural world may or may not translate into performance trends for the full range of asset classes at our disposal. It's not an easy job – but it is an exciting one reflective of the "interesting times" in which we live. We are alert, engaged and fully committed to navigating the rapids and the hidden dangers in the sole pursuit of one objective – the financial success and well-being of our clients.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

MVCM 2008 0010
DOFU: May 2008

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.