MV Capital Management E-Update

Supply and Demand

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Here's a quick economics lesson for all those who didn't take Econ 101 in their freshman year of college. The price of any product or service in a market economy is a function of the amount of that product or service available – the supply – and the extent to which people are willing to put aside other uses of their money to pay for it – the demand. The point at which the supply and demand curves intersect is the market price. That's it – that's microeconomics in a nutshell.

For some reason we rarely consider the supply side of the equation when we look at economics in the real world. Demand is sexier than supply. We all know the iconic images of demand – iPod junkies, "CrackBerry" addicts, crazy-eyed moms fighting over this year's "It Toys" in the malls in December. Much less do we know – or care – about production and delivery schedules at the factory in Taiwan or Guangzhou where the components are being assembled, the paint being applied, the goods being wrapped in bubble paper and put in trucks and ships.

The same goes for the stock market. We tend to look at performance through the demand prism – investors want more Internet stocks or Philippine ADRs or small-cap value names and that's why their prices go up – as if the supply side doesn't matter. But it does matter, and these days it matters even more than usual. Even as we write this article another company – Alliance Data Systems – announces that it is going off the market – the supply of its common stock will no longer be out there for public trading. Radio giant Clear Channel is close to a deal that will remove its shares from the shelf. This week started with the announcement that after decades of trading as a public company Chrysler is for now closing its doors to the equity markets.

We're talking, of course, about private equity. Imagine a giant supermarket with lots of different products on the shelves. Among all the shoppers who come to the store you notice that every day the same four or five people turn up – fabulously wealthy people – and every day it seems that at least one of these rich people announces plans to buy out the entire supply of some product or other. The price of that product will go up in the very short run in response to the impending scarcity of supply, then it disappears entirely and there are fewer products on the shelf. In the language of economics the store's aggregate supply level has gone down. If aggregate demand remains more or less the same then, overall, prices go up.

That, in essence, is what is happening in the stock market. Here the market supply *increases* via initial public offerings. IPOs are nowhere close to their pace of the latter 1990s. On the other hand market supply *decreases* via private equity buyouts. These are setting new records on seemingly a daily basis. Net supply, in effect, is decreasing, and prices are going up.

Private equity is a concentrated business with a small number of unfathomably wealthy megafirms at the top of the pile – the likes of Blackstone Group, KKR, Carlyle Group, Thomas H. Lee Partners, Bain Capital and Cerberus Capital (owners of a new Chrysler). Widely regarded as the smartest of smart money, this small troupe of billionaires has attracted a great deal of institutional equity buying on the heels of their actions. Going back to that supermarket analogy, imagine institutional investors as the ones who rush to buy up the product before it is taken off the shelves – or even better, the ones who try to figure out what those mega-rich guys are going to buy next and rush to get in on that product before an announcement is made.

It's easy to see how this could create a bubble – something becomes attractive simply because enough people think that it could be worth more tomorrow than today, for reasons that have little to do with that something's fundamental value. Animal spirits run wild. In fact the word "bubble" is now in circulation. Recently Jeremy Grantham of money management firm Grantham Mayo van Otterloo wrote a piece on "the first truly global asset bubble" (GMO Market Commentary 24 April 2007). He opined that "the heart of the bubble this time is probably private equity". If so this may be a very, very rare phenomenon – a *supply* bubble as opposed to a *demand* bubble.

Whatever it is seems to be missing the retail investor. Recently brokerage firm TD Waterhouse noted in a release that average daily client trading activity was 9% lower for April 2007 than it was for April 2006. By our own Cocktail Party Theory of Investing metric there is nothing close to Internet or Nifty Fifty proportions on the country club or book club circuits.

There may be three reasons for this. One is that the Internet debacle is still fresh in retail investors' collective memories and they have a newly-found "won't get fooled again" reticence. The second theory is that people don't really understand private equity or relate it to the stock market – there are no Pets.com sock puppets or 20 year-old millionaire secretaries in Silicon Valley to latch onto the public consciousness. Supply bubbles are boring. Third, there is the possibility that real or perceived declines in individual net worth – from falling home prices or falling incomes – are constraining the potential for new retail capital mobilization into equities.

How will it end? Private equity deals involve massive amounts of lending, mostly provided via a small number of large global banks. Banks are supposed to cautiously analyze the risks of their loans – but those risks may look vastly different in a world of ever-higher asset prices than they would in more sober circumstances. Unfortunately the very nature of bubbles is to inspire participants to throw caution ever further into the wind. If the retail investor does stay on the sidelines then this could be a reversal of the usual – a case when the so-called "smart money" gets burned while the "dumb money" stays out of harm's way. Or not – there are several chapters of this story yet to write, and we'll be with you each step of the way.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

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MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax

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