MV Capital Management E-Update

A Tale of Two CWs
July 11, 2006

That sound you heard a few days ago was a collective sigh of relief from investors that the second quarter was finally over. It was not a fun time to be long in just about any given asset class – there was nowhere to hide. The S&P 500 lost 1.44% for the second quarter, and that would have been much worse had the index not rallied by 2.1% on the day before the quarter's close. For the first half of the year overall the S&P gained 2.71%. The Dow Jones Industrial Average, benefiting likewise from the frothy one-day rally on June 29, finished the quarter up 0.94% and for the year to date 5.22%. The Dow's superior performance relative to the S&P seems to indicate that the long-anticipated move to high-quality large cap names may be taking place.

These numbers are not the makings of a tragedy by any means, but then again markets don't have to drop by much to bring the drama queen twins Fear and Greed back onto center stage. In fact the market's performance during the period from mid-May to mid-June (the Dow reaching its lowest point on June 13) fell within the standard definition of a market correction, that being a 10% fall from the most recent peak, which peak for the Dow was on May 10 when the index reached 11,642. This was the first market correction of any significance since the current bull market started at the end of 2002. If it is in fact merely a correction then one would expect this period to register as a blip on the screen while the market continues its overall upward trend.

Or not? The conventional wisdom – or CW – thinks yes. The market has been groping at the unknown – when will the Fed stop raising rates, will inflation come back in full force, what will happen to commodity prices, what about North Korea? – and looking for direction. Corporate earnings are coming out as we write this, and the CW thinks that solid numbers and earnings guidance will give investors some tangible reference points for the second half of the year. There isn't any one particular economic or geopolitical crisis unfolding as we speak. In other words, there isn't a particularly compelling case to make that the correction will turn into a bear market.

But there is another CW out there, called "contrarian wisdom". If conventional wisdom takes the guise of a Pep Squad rally, then contrarian wisdom is more like the sarcastic kids who dress in black and play Dungeons & Dragons. Contrarians perceive an unease lurking behind the generally positive economic growth, employment and other statistics. They latch onto somewhat arcane "what if?" scenarios to counter the consensus opinion. What if long term bond rates in Japan increase at a faster pace than expected? Perhaps all the hedge funds that have been financing global asset purchases with ultra-cheap Japanese debt issuances will pack up and pull out of those exotic high-risk markets that have done so well recently. Credit spreads will skyrocket and Brazilian stocks will tank, right?

Not necessarily. We tend to see both "wisdoms" as having something to add to the conversation but also believe it can be myopic to subscribe to only one mindset. CW-1, the conventional, tends to focus on a rapidly formulated assessment of the here and now. CW-2, the contrarian, delights in the construction of more elaborate arguments that showcase an intelligent, but not always practical and temperate, mind.

We prefer to trust our own minds and do the analysis ourselves. Take the issue of risk, for example. Are markets becoming more volatile again? We looked at the volatility of the S&P 500 over the period January 2004 through June 30 2006, with volatility defined as the standard

deviation of the average daily return for each month of analysis, and as an additional measure the number of days in any month where the index moved up or down by 1% or more. We found that by these measures May and June of 2006 were no more volatile than other consecutive two month periods when the S&P was negative (this happened in March-April of both 2004 and 2005). This is not particularly surprising – in a bull market trend, the brief downturns will tend to be more volatile than the overall average. In other words, nothing to argue this is anything but a simple correction.

Or not. There is still plenty of uncertainty in the market, including mixed messages coming out of the first set of corporate earnings figures and an unformed consensus on inflation. Inflation doesn't cause volatility – uncertainty about inflation causes volatility. And while there is no one single crisis out there today there are enough potential X-factor ingredients to make an unpleasant surprise cocktail – a lurking unease, as the contrarians might say. In both equity and fixed income we continue to keep our bias weighted towards areas such as mega cap stocks and AAA short-term debt while looking for attractive value opportunities among riskier segments. Our target commodity position is view-neutral at 5% of portfolios which we believe is appropriate for diversification purposes.

And regardless of what the conventional or the contrarian wisdom of the moment happens to be, our commitment remains the same that patience and discipline are the wisest defenses against whatever it is the market will bring us as we move into the second half of the year.

With warm personal regards,

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