MV Capital Management E-Update

Bad Medicine and Good Health

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How healthy are you? When we ask that question it could have two meanings. The first might be: how are you feeling today? Are you doing okay or a little run down? The second could be: how healthy are you generally? Are you always in the doctor's office or do you almost never miss a day of work? The answer to the question "how healthy are you?" depends on whether it relates to the short term or the long term.

Over a period from January 1, 1979 to June 30, 2007 the S&P 500 Index, a broad measure of US stocks, returned an annual average 13.5% with volatility (standard deviation) of 14.8%. For the same period the Lehman US Aggregate Bond Index returned 8.7% with volatility of 6.0%. Put another way – over this long term period stocks returned a bit less than twice what bonds did, with a bit more than twice the risk. That is consistent with observations over other long term periods. It's a picture of pretty robust long term health.

About a year ago stocks started to rally big time. From July 1, 2007 to June 30, 2007 the S&P 500 gained 20.6% with volatility (standard deviation) of 6.7%. That amounts to outsized equity returns for a bond-like level of risk. Such low risk levels tend not to be sustainable over long periods of time. Things happen that cause risk to reprice. Risk repricing is in fact what is going on in the markets today. That's the bad news – that's the cause for the stomach-churning stock market plunges we've seen on days like yesterday. The good news is that there's nothing out of the ordinary about this. Risk repricing is like a particularly bad-tasting medicine – it's not fun while being digested but it's necessary for the sake of long term health.

So let's focus on those two things separately – the short term health issues causing this risk repricing and the long term health of the markets. To understand the short term health picture in the equity markets we have to look at the credit markets.

A major force driving that 20% stock market return over the last year has been private equity dealmaking. Private equity deals rely on a huge amount of credit financing – banks lend billions of dollars to buyout investors who use the debt to pay for the common stock of their target companies, and then pay back the debt with the cash flows they expect the businesses to generate. Much of this debt is considered speculative – high yield, not investment grade. In recent weeks this market has appeared to be reaching saturation levels. Financing deals have been put on the shelf, leaving the buyout investors to either come up with the money themselves or simply walk away. Either way it has a slowing effect on the private equity market, which in turn throws a blanket on one of the prime movers of the stock market rally.

Another factor in the credit markets is continuing bad news in the subprime loan market. Here there are really two issues. One has to do with the fundamentals of the housing downturn and the subprime loan mess – is the worst behind us or are things going to get even worse in the fall when the interest rates on a bunch of these loans are reset and homeowners' monthly mortgage bills double? There's no real consensus on the answer to that question.

The second and in our minds more influential issue is how the large numbers of securities derived from subprime loans are priced relative to their actual risks. When a mortgage lender makes a subprime loan it starts a whole chain of events. The lender sells the subprime loan

onto another financial institution that aggregates a bunch of similar loans and sells the resulting pools onto big Wall Street investment banks. The Wall Street propeller heads then slice and dice these loan pools and create exotic-sounding things like "collateralized debt obligations" and "enhanced leverage funds" and sell them onto yield-hungry investors.

The problem is that these exotic securities are relatively new and their performance has never been tested in a down market. What has the markets spooked now is a lack of understanding how bad the fallout could be if these highly leveraged securities start to unravel. That could be a contagion that spreads to all risk assets, including the equity markets.

So that's the bad news – the bad-tasting medicine we are dealing with now. The good news is that the market's long term health has very little to do with buyout financing or exotic derivative securities. Rather, it derives from the health of the global economy and sustainable cash flows generated by companies competing therein. Looking at the economy today we don't see a very different story from what we've seen over the last year. Despite the housing slowdown economic growth has generally been better than expected for this point in the cycle. Second quarter GDP came in at a higher than expected 3.4% which is almost right in line with the US economy's long term economic potential. Inflation has caused a bit of hand-wringing but is only slightly above the Fed's comfort level. The global economy, led by continued robust growth in China, India and other emerging markets remains broadly vibrant.

For the time being 20% average annual returns may be behind us, but we don't have much cause to see a gloomy road ahead. At the beginning of this year in our annual market commentary we made a case that equity market returns in the high single digits may be what 2007 has in store. If anything, the economic data points we've seen since then may give us cause to revise our assessment upwards. In the aftermath of yesterday's plunge the S&P 500 is still up around 5.7% year to date and international markets even more so. We've still got most of the second half of the year to go. Of course the short term is completely unknowable. But at this point we're inclined to see more evidence than not of sound long term health.

With warm regards,

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