MV Capital Management E-Update

Market Tectonics, Balance Sheets and You

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The financial sector of our economy is going through momentous, necessary changes and will look very, very different on the other side of this market meltdown. Meanwhile life, economic and otherwise, goes on.

These are two things worth keeping in mind while the tone of public discourse and commentary escalates to fever pitch. The extremely volatile equity markets we are witnessing reflect certain forces of fundamental economic realignment. This is the economic equivalent of geological plate tectonics – they move along slowly and unremarkably for years, but when the plates collide the fireworks are spectacular. But this kind of realignment is *not* unprecedented. It's not "different this time" as the hyperventilating commentariat likes to proclaim.

So in this e-update we're going to look at the fundamentals behind the fireworks – but first and foremost we want to emphasize the importance of keeping a cool head and resisting the easy road to fear. Especially in times like these – the "interesting times" of ancient Chinese wisdom – discipline and patience are qualities of paramount importance.

In the realignment of which we speak – the market tectonics – we see the juxtaposition of two strands of the economy that for much of the past 25 years have been intertwined, mutually supportive and increasingly dominant as a share of economic activity. These are: on the one hand, the phenomenon of financial innovation that has revolutionized the way we borrow, spend and invest; and on the other hand the explosion of consumer choice that has risen to meet our expanded financial decision-making scope. As the economy evolved from the old "cash and carry" model – the legacy of a previous generation scarred by the experience of the Great Depression – to the "buy now, pay (much, much) later" paradigm of today, a great deal of brainpower and energy from our country's brightest minds have gone into creating more things for people to consume and more innovative ways to finance the consumption. At the heart of this current financial crisis is one word that sums up the convergence of financial innovation and consumer markets in hyperdrive – *leverage*.

To understand this let's express it in the standard language of finance – the balance sheet. The left hand side of the balance sheet consists of assets – things of value to their owners. On the right hand side of the balance sheet are liabilities, reflecting what we owe to other people. The subtraction of liabilities from assets results in our financial net worth.

Leverage happens when we borrow in order to acquire something. There's nothing fundamentally wrong with leverage – everyone who takes out a mortgage to buy a home is using leverage to reach the desirable goal of home ownership. The problem is the leverage *ratio* – or the value of the asset compared to the amount of debt assumed in relation to it. What we are seeing in the stock markets and in the economy at large is a reflection of leverage ratios gone wild, where for every dollar of some asset – a home, a car, a Viking barbeque grill – there are twenty, thirty or more dollars of related debt outstanding.

That is true for the balance sheets of single-family households and multi-line financial institutions alike. The asset side of the balance sheet has declined with the sustained decrease in home prices. That leaves liabilities worth more than assets – resulting in negative net worth.

The only two ways for a household to deal with negative net worth are either to sell off assets or declare bankruptcy. Same goes for financial institutions, except that they have the one additional option of swooning and falling into the arms of another institution – thus the sad end to the storied histories of Bear Stearns and Merrill Lynch.

Selling assets in desperation is a value-subtracting activity as it puts downward pressure on economic prices generally – thus further deflating the value of those balance sheet assets and compounding the ills of those leverage ratios run amok. In the pantheon of economic woes asset deflation is among the worst. When the Fed cuts interest rates it is doing so in part to head off the threat of deflation. Unfortunately the Fed's efforts to cut rates over the past year have not had the desired restorative effect, and today it is boxed in between the asset deflation beast on one side and that of commodity price-led inflation on the other. In the past rate cuts have proven to be an effective policymaking tool for stabilizing markets, but for now this tool is not on the table.

So after reading that litany of bad news you may be inclined to go back to the beginning of this letter and say: wait a minute – if things are so dire then why are these folks telling me to stay calm? Shouldn't I be getting out of this mess entirely?

The answer in our opinion is a resounding: No. Panic selling is the twin side of the Janus-faced Wall Street specter of Fear and Greed. It is the worst form of market timing – and market timing is an ill-advised tactic in any form. In his book *More Than You Know* Michael Mauboussin delved into the market timing question. He observed that from January 3, 1978 to October 31, 2005 the S&P 500 returned 9.6% (excluding dividends). The return for the same period *excluding the 50 worst days* was 18.4%, while the return *excluding the 50 best days* was 2.2%. Those results are consistent with other market timing studies we've seen that all offer the same conclusion: absent a crystal ball to warn you when the extreme days will occur, it simply doesn't make sense to try and time the market.

Long-term investing involves making strategic decisions about the composition of portfolios in pursuit of defined financial objectives while taking into account the client's ability and propensity to assume risk. At its core this means determining an appropriate mix of equity and debt based on the long-term risk and return characteristics of these two basic investment categories. By long term here we don't mean three, five or ten years – we mean for as many years as there exists quantitative performance data about stocks and bonds, which is a very long time indeed. Around this basic long-term strategy we also make shorter-term tactical decisions – weighting our exposures across multiple equity, debt and alternative asset classes in line with our views on cyclical and secular economic trends and developments.

Our tactics augment our strategy – they do not replace our strategy. We do not dump everything and go all-cash when the market tanks. We do not throw everything into Internet stocks or REITS when those markets are soaring to the stratosphere. We do not believe "this time it's different" should ever be a notion that drives the decisions we make in our weekly Investment Committee meetings. That is true when the markets are good and when the markets are terrible. In the long run we believe that staying true to this approach represents the most likely way for us to succeed in the one thing we care about above all others – putting our clients in the best possible position to win in realizing their financial goals.

We'll be sharing more with you over the coming weeks and months about the opportunities we see emerging from these tectonic collisions taking place today. In the meantime our phone lines, email in-boxes and office doors are open to any concerns, questions or thoughts that you may have on your mind. We suggest taking a deep breath, remembering that this, too, will pass. Our economy is resilient. It's really not different this time. But it certainly is interesting.

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