MV Capital Management Thought Leadership

October Surprises
October 7, 2011

The S&P 500 briefly entered bear market territory on Tuesday, extending the magnitude of its losses to more than 20% from its 52-week high point. Downside momentum accelerated through the mid-afternoon hours, as has become the custom. Then, in the mere blink of an eye, the trajectory reversed course, bravely scaled the digital *Jungfrau* and turned a 2.3% loss into a 2.5% gain for the day. The Dow Jones Industrial Average registered a 421 point shift from its intraday low to the close. The reason for this reversal was…well, there were no real reasons, as usual. Just the trigger-happy algorithms reacting to packet-switched news feeds from Greece, or the IMF, or the latest jobless claims numbers, or whatever else motivates the machines to deluge the trading systems with buy and sell orders. Welcome to another October and its *danse macabre* of tricks and treats. This year shows all the signs of being a real lulu of a ride.

What is it about October? From 1929 through Black Monday of 1987 and on to the debacle of 2008, this month can be scarier for investors than the Three Witches of *Macbeth* cackling over their boiling cauldron with eye of newt and toe of frog. There are various theories out there. From our standpoint the most plausible argument is probably that managers start to position their portfolios for year end. If the trend is positive as October gets going then managers pile on in order to dress up their portfolios with the in-favor names and sectors. We saw this last year and in 2009. But if the landscape looks dicey then those managers are likely to take a bunch of positions off the table to lock in gains (or minimize losses) for the year. That downward momentum can feed on itself and become a meltdown.

Following the sharp drop in the aftermath of the debt ceiling shenanigans in early August, the markets have been trading in a largely sideways pattern. On August 8 the Dow closed just above 10,800. Two months later on October 5 the Dow was 10,939 at the closing bell. But the journey has been less of a straight line and more the zigzag lurching of a very inebriated being. During this two-month stretch the Dow has notched a high water mark of 11,613 and plumbed the depths at 10,655 – a difference of more than 1,000 points. And that's just based on closing prices – intraday points have been higher and lower still. The volatility has been daily and it has been relentless.

We have made some tactical allocations to cash over the last few months, mostly by taking positions off the table in the international equities sectors where the crisis flashpoints have been. We are going to continue building a more defensive posture over the coming weeks, across a more expanded subset of risk asset classes, to provide a higher than usual downside protection level to the portfolios under our management. We are taking this action, not because we see fundamental changes to the overall economic picture (weak organic growth, likely continued intervention by central banks to provide some artificial stimulus) but because we see confidence as being very fragile and commensurately a raised

probability for further downside movement. Our primary objective in this exercise is preservation of capital –which will involve sacrificing some upside potential in order to guard against catastrophic loss.

Could we be caught on the wrong side of that trade? It is entirely possible that some catalyst will bring about a sustained rally between now and year end. A clear sign that Europe has moved past the worst of its problems, together with a run of better than expected macroeconomic and corporate earnings data points, could move the arrow back to the bulls' camp. However we see little evidence to convince us of any new morning in Europe. Investors are trading the headlines, and those headlines continue to be as contradictory and obfuscated as they have been throughout this drawn-out crisis. Greece stands in high likelihood to default, and more systemically critical countries like Spain and Italy are still at the edge of the abyss. Large European banks are highly exposed to these flashpoints and may not have the capital reserves to weather the potential impact of default. Meanwhile the US is still keeping its distance from a second recession, but the buffer zone is not robust and the rate of growth is below the level required to sustain positive job creation. As the poisonous political climate moves into full-bore election year, don't expect anything helpful to come out of Washington.

In a climate like this the prudent thing to do is to raise the defenses. To restate what we said above: our primary responsibility is to preserve our clients' capital to the best extent possible given all the capital markets forces at play. Until we see a return to more normal levels of volatility that responsibility is best met by reducing the potential exposure to the asset classes that could fare worst in another meltdown.

With warm regards,

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