MV Capital Management E-Update

A Day in the Kayak

August 8, 2007

You have heard us refer in these e-updates to the image of being in kayaks, paddling down the river alert to what may lie around the next bend. To properly reflect the realities of current market conditions we need to change the image slightly from river to sea kayaking – specifically on a heaving, stomach-churning sea where our little boats rise to great heights and plunge to cavernous depths seemingly every few minutes. The closing numbers you see on the evening news hardly do justice to the intraday gyrations this market has been going through over the past couple weeks. In this e-update we want to invite you into our world.

Our computer screens are set to a montage of US and international equity, debt, currency, commodity and other markets. The information is real time so you see the graphs change in response to buying and selling activity. Green means up, red means down. Although we didn't take an actual count we think last week set a record for the number of times the major US stock market indices – the Dow Jones Industrial Average, the Nasdaq Composite and the S&P 500 Index – moved from red to green and back again during the course of the trading day. And we're not talking about little moves of a few points north or south of where the market opened. We're talking 100 point gyrations by the Dow up and down, with a particular penchant for high drama during the last 20 or so minutes of trading.

Looking at these volatile trading patterns makes you wonder who is doing all this buying and selling. As the indices flash urgently between red and green like a Christmas tree gone berserk it's easy to conjure up an image of panicky humans in the conference rooms of investment institutions around the country, mopping their sweaty brows, gulping coffee and wolfing down Krispy Kremes while they bark transaction orders into the telephone. "Bernanke's up in 15! I have this bad feeling in my gut! Get Charlie on the phone and dump all our bank stocks, now!"

In fact, very few of the decisions behind the deluge of late-afternoon purchases and sales are made by human deliberation. The key humans involved are the software geniuses who write the code that goes into the sophisticated computer trading programs institutional investors employ. These programs go by various names like portfolio insurance and systematic stop-loss triggers. Institutional investors such as municipal pension plans, life insurance companies and university endowments use these programs as risk control measures for their multi-billion dollar portfolios. This is somewhat akin to a temperature gauge on a complex piece of machinery, say in an engine room. The gauge is set so that if the temperature rises to a predetermined level it triggers an automatic corrective reaction to mitigate damage. When the S&P 500 falls or rises to a certain intraday trading level (the market's "temperature") the machines kick in and flood the exchange floors with orders. That's a big part of what makes the swings look so dramatic.

What do these gyrations tell us about the overall direction of the market? The somewhat cynical answer would be to say: nothing much. Short-term performance in periods of high volatility almost never gets it right – the market is in a near-continual state of being overbought or oversold. Last Friday the markets oversold – the major market indices all fell by more than 2% and the S&P 500 was back to where it was at the end of March. On Monday of this week traders came back in and concluded that the market was oversold, so they bought all day and then the institutions' temperature gauges went off a bit after 3 pm and the machines spewed out buy orders to push the Dow, S&P and Nasdaq up by more than they lost on Friday. We feel it is quite likely we will be seeing more of these Kabuki-like theatrics over the coming days and weeks. For us these theatrics are a distraction. We are interested in trying to figure out the longer-term trends and positioning our clients' portfolios to be in the best position to benefit from these trends. When the Dow lurches up 200 points then back down 150 points and then up again we have to pay attention – but it is a distraction from our real analysis and deliberation. So let's put aside the intraday craziness for a second and look at the bigger picture.

Credit market weakness is a real issue. It will likely have a more pronounced negative effect on those companies and industries that most directly benefit from conditions of cheap credit and easy liquidity. That means banks and mortgage lenders, of course, but it goes further than that. Companies that need to go to the debt markets frequently to raise capital are going to have a harder time of it, especially smaller-cap companies that are more likely to be speculative-grade credits. It also may affect companies and sectors whose operating cash flows tend to be more unstable – including high-growth sectors like biotechnology as well as capital-intensive industries with more volatile demand cycles like certain consumer discretionary segments.

Healthcare is another sector we are not excited about for different reasons – the run-up to the 2008 presidential elections is going to put this sector in the spotlight of uncertain political speculation – and Wall Street dislikes uncertainty more than anything else. On the other hand we like the prospects for companies with strong balance sheets (low debt, high cash balances), good access to export markets (weak dollar), and longer demand cycles (especially from resource-hungry Asian markets like China and India). We are making some tactical decisions that reflect these views. Because, irrespective of those red and green flashing graphs that clamor for our attention throughout these volatile trading days, we are doing our jobs best when we focus on ways that we can create real value through our analysis. That means riding out the short term crests and troughs we cannot control and keeping our eyes on the path forward.

With warm regards,

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