

Memo

To: MDE Clients & Friends
From: The MDE Group
Date: October 14, 2008
Re: **Some Rational Thoughts for Irrational Times**

Riding the Roller Coaster of Fear

As we write this commentary on Monday, October 13th after a near historic worldwide equity market rally, like everyone else we are still somewhat shell shocked over the events of the past week. Since the news of last week's 18% historic decline was hard to miss unless one was marooned on a desert island, we will not rehash the details of this surreal experience. Suffice it to say, the markets became completely irrational and were in full-fledged panic mode with selling begetting more selling. The results were magnified by forced selling as hedge funds and long-term investors alike received margin calls and were forced to liquidate shares at substantially discounted prices. This irrationality spread into nearly all asset classes creating a contagion of selling that resulted in across the board declines in nearly all investment vehicles except cash.

As the events of the week unfolded, to paraphrase former GE CEO Jack Welch in a recent CNBC interview, we at MDE were not "hiding under our desks sucking our thumbs." While any attempt to react to this unprecedented market action would have been impossible and likely counterproductive, we spent considerable time speaking to multiple sources and attempting to understand, as best we could, the framework in which these events were occurring. To state the obvious, markets function based on confidence. At the risk of over simplifying last week's market activity, as the credit market lost confidence in its ability to be repaid, lenders stopped making loans causing the credit market to freeze up. With credit markets frozen, the stock market feared that, with the key lubricant of our economy withdrawn, its gears would cease to function. As a result, irrational fear gripped the stock market and it sold off indiscriminately. This fear was in part illustrated by the VIX, a volatility index, which measures market gyrations. While its average since inception is approximately 20, the VIX peaked last week at 76. The change from its long-term value represents a "seven sigma" event. In other words, it should normally not occur more than once every million years.

Overcoming Emotions and Irrational Fear

As long-term investors and not day traders, we attempted to view these irrational events against a background of rationality. We make no predictions as to whether, when, or at what level the stock market either has or will find its bottom. However, in addition to the aberrational heights attained by the VIX, the following factors provide a rational basis to believe that the market is behaving irrationally and likely trading below its long-term fundamental value.

- The S&P 500's P/E of 13 is well below its long-term average of 15, and its twenty-five year average of 20. The undervaluation seems even stronger given the historically low levels of interest rates, inflation, and taxes. Through October 10th, the S&P 500 had declined 45% from its October 2007 peak – significantly in excess of the average 28% bear market loss over the past 50 years.
- Unlike the time of the Great Depression, there are certain long-term stabilizers, such as automatic retirement plans, 529 college plans, etc. that continually add fresh capital to the markets.
- A portion of the substantial \$1 trillion cash balances held by cautious or panicked investors will eventually return to the market once confidence is restored.
- Warren Buffett, the richest person on earth, and perhaps the greatest long-term, value investor ever, has begun investing in high quality companies such as Goldman Sachs and General Electric. Buffett is well known for his quote, “Be greedy when others are fearful and fearful when others are greedy.”
- Some “perma bears” are beginning to come out of hibernation. We took note when John Hussman, with whom our clients have been invested since 2003, and who has been fully hedged nearly this whole time, uncapped one half of his short position at the end of the prior week. At that time, the S&P was still hovering slightly below 1,100. In his October 6th weekly market commentary, Hussman indicated that he found the markets sufficiently attractive on a long-term basis to warrant exchanging some of his long-held downside protection for unlimited upside appreciation.

Perhaps the best reason for our adherence to a more rational perspective is that the current credit crisis has the full attention of key political and financial leaders of every major economic power. While U.S. policy responses over the past weeks and months have been well documented and debated, last week the major European economies had begun to discuss and implement plans of their own. The leaders of the G7, a group of the richest nations in the world, have pledged to cooperate to solve the financial crises during a series of meetings that occurred the weekend of October 10th. On October 12th, the leaders of the major European countries agreed on a framework, the scope of which goes beyond the so-called U.S. bailout legislation signed into law on October 3rd. Since that time, the intended implementation of that plan has been expanded to give the Treasury more tools to deal with the financial crisis. It is anticipated that on October 14th, the Treasury and the Fed will announce even broader tools, to match those agreed to by the Europeans.

The government has been attempting to deal with the developing financial crisis on an ad hoc basis for the past six to nine months, reacting to developing events as each crisis developed. While we at MDE tend to prefer free market solutions, in times of extreme crisis, government support is sometimes the only solution. The fact that a comprehensive plan with considerable flexibility seems to be emerging should give the markets reasons to be encouraged. Perhaps the most encouraging sign is the near agreement on the part of the twenty largest economies around the world on the need for a comprehensive course of action. However, we must be mindful that these plans are very complex and will take weeks, if not months, before implementation has begun. Once fully functioning, these plans will likely take many additional months, if not more, before their effects begin to be felt by the broader economy. However, over the near term, the key is for financial markets to believe that the depth and breadth of the problems are well understood and that the tools created will be effective in ultimately solving these problems. This is the key to restoring confidence to the financial markets over the near term, although the effects of the plans will not be felt until some time in the future. However, the lingering fear is that the government will overreach in its response, and necessary short-term responses will morph into long-term impediments that will constrain long-term economic growth.

Even if confidence in the financial markets is restored in the coming days or weeks, we are likely in, or facing, a recession, the depth and duration of which can only be speculated upon. However, the stock market is a discount of future events.

While some that we speak to make the case that the markets may have already discounted all or much of the recession into its current levels, we will not know this until after the fact. We do know that historically, markets begin to turn up some six to nine months prior to the economy. However, we should continue to brace ourselves for additional choppy waters ahead.

Weathering the Storm

When confronted with a storm in the middle of the ocean, unless one fears the ship is so damaged that it will sink, it is far more dangerous to abandon ship than to ride out the storm. Such is the case in the midst of the turbulence affecting the financial markets. We have long commented on the futility of market timing. Few, if any, have done it consistently and the strategy requires accurate exit *and* reentry points to work properly. A well-known study by the University of Michigan examined the performance of stocks over the 1963 to 2004 time period. Over the entire period, the stock market returned approximately 11% per year. However, for investors who missed the 90 biggest gaining days over the entire 40+ year period, their returns shrunk to only 3.2% per year. Furthermore, less than 1% of the trading days accounted for more than 95% of the market's gains. Similar studies have been conducted on markets around the world, reaching the same general conclusions.

While we are not market timers, but neither are we mere passive observers. We are long-term strategists who are looking through this current storm to the other side. We have developed and implemented strategies, and will continue to develop and implement strategies, which will serve our clients' interests over the intermediate and longer term.

On September 17th, we fully implemented our recommended strategy of transferring 20% of our clients' equity portfolios to a basket of hedged mutual funds. From this date through October 10th, the S&P 500 was down 22.24%. Over this same period this basket declined by only 11.41%, protecting approximately half of the market downside of this portfolio while still preserving substantial market upside potential when the market recovers.

With respect to the separate accounts we manage, we have complete daily transparency into these portfolios. We use this transparency to determine, among other things, the interrelationship of our managers and our overall portfolio construction. In observing these portfolios to understand our clients' market exposures, we noted that many of these managers held substantial cash positions. While each client's portfolio will be different, on a weighted average basis, our separate account equity managers held an average of 16% in cash last week, further reducing client equity exposure.

We have also been in continual contact with these managers to understand not only their market outlook, but the rationale for the portfolios they hold. From time to time, we may find ourselves in disagreement with some of the actions taken, or positions held, by some managers. However, in our open architecture approach to long-term investing, we understand that different managers will, from time to time, take positions with which we may not agree. However, the reason we employ open architecture is to bring a variety of different perspectives and approaches to the investment process. As such, we understand that different managers will perform better or worse than others over distinct time periods. With the benefit of 20-20 hindsight, it is easy for us to be critical of certain security selections. However, since no one has a crystal ball, our test is whether the selection of a particular security was logical, well researched, and appropriate within the context of the portfolio at the time investment decisions were made, not after the fact.

Looking Beyond the Turmoil and Capitalizing on Opportunities

As we look toward the future, we believe that near-term market dislocation creates long-term opportunities. As such, we will use the recent market declines to better reposition our clients' portfolios for the future.

We will start by implementing our *Silver Lining* tax loss harvesting program beginning later this week. We usually implement this program in December. However, given the magnitude of the market declines, we want to make sure we give separate account managers sufficient time to harvest losses throughout their portfolios without creating a major disruption to the underlying portfolio construction. Likewise, we will do the same directly, on a tax lot specific basis, for the mutual funds we manage. We anticipate these harvested losses will provide loss carryovers into next year and beyond. To the extent there is an increase in capital gain tax rates during a new administration, these losses could prove more valuable in the future.

We will also take the opportunity between now and the end of the year to review all client portfolios, and to rebalance where appropriate. As a result of the market turmoil, new opportunities are being created while other investments need to be rethought. Some investments have been discounted to levels where they are more attractive than at any time in recent years. While it is emotionally difficult to invest more money in an investment that has just lost money, after careful research we may recommend that approach in select cases. Conversely, other investments that have done poorly may not be well positioned for a strong recovery and we may recommend reallocation of these sums into other investments better positioned for a recovery. We have had several new managers in different asset classes under review for some time. In some cases, we had been reluctant to engage these managers, since we felt their asset classes had additional downside. While we will proceed slowly, the timing may be good to begin gradual engagement with one or more managers.

We are in the process of formulating an action plan for the ongoing evolution of our client portfolios. However, as in all we do, we will be thoughtful – carefully evaluating and analyzing any action. As always, we will likely proceed slowly, erring on the side of caution. All actions will be communicated in advance and likely implemented over time.

Volatility will not disappear in short order, due to the continuing fear, tax loss selling, and de-leveraging processes that are still taking place. In our view, broad and intelligent diversification is, and remains, the best and perhaps only viable long-term strategy to weather an extremely volatile market. While we cannot eliminate this volatility, rest assured we are not “hiding under our desks sucking our thumbs.” We are looking beyond this correction, and will do our best to attempt to use this volatility to best position our clients’ portfolios for the future. The entire team at MDE stands ready to ensure that you remain comfortable and committed to your long-term financial plan. As always, we thank you for your loyalty and support. It is during these trying times that we truly attempt to earn our reputation as *your family’s most trusted advisor*.