



THE MDE GROUP, INC.

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Memo

To: MDE Clients & Friends
From: The MDE Group, Inc.
Date: November 6, 2008
Re: **Living Through History**

Sticker Shock

Investors throughout the country are about to receive their October 2008 investment statements. While investors likely have been glued to the nonstop news coverage of market gyrations, they may nevertheless suffer “sticker shock” when they see the actual effect October’s market turmoil has had on their current account balances. On the whole, our clients’ diversified portfolios have somewhat mitigated the near-term declines in their balances caused by October’s virtually unprecedented market action. In addition, our clients should find comfort in the fact their portfolios did not suffer any material capital impairment, and we believe these declines will be reversed over time. Nevertheless, they should be forewarned to brace against the impending sticker shock from their October statements.

Over the past five plus weeks, we have all experienced a confluence of extraordinary events that history would have deemed to be highly improbable just a short time ago. Yet we are living through history that will be studied by future generations. In addition to the financial crisis and the historic market declines which marked October, on November 4 we elected a new president – the first African American to ever hold the highest office in the land. Only time will tell which of these two events will loom larger when viewed by historians. However, no one will argue that both events are likely to affect all of our lives for years to come. As the financial direction of the new administration comes into focus, and specifics begin to emerge, we will provide some perspective on the November 4 elections and their potential effect on investing. In this commentary, we will attempt to place the events of October 2008 in context and provide some preliminary perspective as to how these events may shape our future investment strategy.

This is the Month that Was – Wall Street Style

Perhaps the best thing that can be said about October is that it is over. October 2008 was the worst month in stock market history since the infamous Crash of 1987. The monthly decline in October 1987 was 21.5%. By way of comparison, on the heels of the worst September on record, where the S&P declined by 9.0%, the S&P suffered an additional 16.7% decline during October. To further illustrate the magnitude of October’s market disruptions, the rally during the last four days of the month trimmed October’s losses by 10.4%. Without this closing rally, the monthly loss would have been a staggering 27.1%.

The worldwide financial markets fared even worse as the MSCI ex U.S. index declined by 20.3%. Other than cash, there was literally no safe place to hide as investors fled nearly all investments to the perceived safety of short-term U.S. Treasury instruments. While portfolio diversification served to somewhat mitigate the downturn, it could not prevent substantial losses. Even hedge funds declined by an average of 9.1% for the month of October and are down 19.6% YTD according to the HFRX Global Hedge Fund Index. Perhaps the greatest surprise was the intra-month volatility exhibited by the normally “safe” high quality bonds. By way of example, the SPDR Lehman Muni Bond ETF

(which is invested 58% in AAA, 42% in AA bonds, with a nine-year duration) experienced a price drop of approximately 15% from its September 12 peak to its October 16 trough. This aberrational movement took place in an environment of declining global interest rates in which bonds generally appreciate. Such extreme declines in the bond market reinforced investors' unwillingness to assume any type of risk.

Extreme Volatility Punctuates Investor Fear and Panic

Many words come to mind to describe the market in October, not all of them printable. Of all these words, perhaps the best would be “fear and panic” which manifested themselves in unprecedented volatility. This extreme market volatility led to a “negative feedback loop” driven by many factors. A major driver of the volatility was the massive deleveraging by all financial institutions – most notably large hedge funds which had to sell assets to meet quarter-end client liquidation demands. This forced selling became circular as it led to pure irrational panic in the marketplace, which in turn caused mutual funds to liquidate large positions at the end of the trading day to meet client redemptions. This combination of events in turn led to huge declines in the closing minutes of each trading day. These erratic and unpredictable moves fed on themselves and created a negative feedback loop which led to more selling...which caused more deleveraging...which caused more panic, etc.

October opened with the S&P 500 falling by 18% during the week of October 6, followed by an incredible 11.6% increase on October 13. A virtual replay of the precipitous decline followed by a quick, rapid rise occurred a little more than a week later. The S&P 500 fell 13.9% over the five trading days beginning on October 21, followed by a surge of 10.8% on October 28.

As if the daily volatility was not sufficiently gut wrenching, the intraday volatility was even worse. The S&P 500 started the month with eight straight losses, imploding from 1164 on September 30 to an intraday low of 834 on October 10 – a decline of 28.35% over a mere eight trading days. Over the course of the month the market exhibited almost unimaginable volatility with 14 days showing intraday swings of 5% or more, five days with intraday swings of 9% or more and two days showing intraday swings of 10% or more. The VIX volatility measurement, or so called “fear index,” peaked at an historic 89.5 on October 24 before declining to 59.9 on October 31. These extreme levels compare to a long-term average of approximately 20 since the index was created. The S&P tested its October 10 intraday lows several times during the month, the latest test being on October 28 when the S&P reached 845 before closing the day at 940 – a near historic daily increase of 11.2%. On the positive side, the S&P closed October with a weekly gain of 10.5%, its first weekly gain after four consecutive weeks of losses.

Help is on the Way – A Governmental Rescue for Free Market Woes

October's extreme volatility was caused in large part by widespread investor fear of an imminent implosion of the worldwide financial system as we know it. The primary reasons for this market reaction, or overreaction, are well known by this time and have been discussed in our previous commentaries of September 18 and October 14. The good news is that fear of this systemic collapse seems to have abated. The unprecedented strong and coordinated policy responses of The Federal Reserve, U.S. Treasury, and their counterparts around the world, have sent an unmistakable signal that restoring the global financial system is of the highest priority. While we will not go into the myriad details surrounding these complex plans, the primary takeaway is that governments of the world's largest economies, led by the United States, have essentially “backstopped” important financial institutions, making it highly unlikely that they will fail. In so doing, the risk of a systemic collapse of the global financial system has been dramatically reduced.

The financial markets slowly, but surely, may be coming to this conclusion. While only the future will tell, a base forming process may be underway after the stock market reached its intraday low on October 10 and re-tested, but did not breach this low on several occasions. However, investors should not be surprised if these lows are again re-tested as part of this base forming activity as markets react to future unfolding events.

Perhaps of greater importance, the three month LIBOR rate (the rate at which banks loan to each other) has declined from a peak of 4.8% on October 10, to a rate of 2.5% as of November 5. However, the spread of LIBOR over Fed Funds (i.e. the rate at which the Fed loans to member banks) still remains at 1.5% compared to an historical spread of less than 0.5%. That said, the decline in LIBOR seems to indicate that the governmental interventions may have begun to restore some confidence to the financial markets and that banks are becoming more comfortable with beginning to loan money – at least amongst themselves. This is the first step in re-lubricating the financial system that ultimately runs on credit.

These promising developments are not to say we are “off to the races.” Far from it, since the policy responses are only weeks old and will take additional weeks, if not months before the proper infrastructure is in place to fully implement these policies. Once implemented, it will take many more months before the effects of this wide spread governmental intervention is felt by the economy. However, since markets run on confidence and are discounters of the future, the mere announcement and partial implementation of a comprehensive worldwide policy response seems to have served the purpose of calming an irrationally panic stricken market.

While the financial panic may have receded and the markets may be in a base building mode, there are still storm clouds on the horizon. We are likely facing a worldwide recession, the duration and severity of which continues to be the subject of much speculation. While a recession is never welcome news, to the extent the markets react to bad economic news, at least it will be trading on fundamentals and not irrational fear and panic. However, we have reason to hope that the massive fiscal and monetary policy responses already in place will short cut this recession in both its severity and duration. In addition, it is widely anticipated that a substantial additional fiscal stimulus will be forthcoming from the new administration and congress. This stimulus should have a positive effect on the economy over the near term and could serve to further short circuit the recession. However, the long-term implications of an additional excessive stimulus, combined with the already substantial current budget deficit and cumulative national debt, could have negative long-run implications in terms of inflation and the strength of the U.S. dollar.

In addition to the financial rescue plan and the expected additional stimulus, the following are additional signs that the market may be in a base building process and may have already discounted the recession which is likely to dominate much of 2009:

- The dividend yield on the S&P 500 is now approximately 3%. This can be compared with a yield of 1% in 2000. This reflects good fundamental value in the broad based market.
- Depending on which measure is used, the price to earnings ratio on the S&P 500 is at or below its historical averages.
- The price to book ratio on the S&P 500 is approximately 1.8 – a level not seen since the mid 1980s.

Looking Toward the Future

After nearly every crisis, be it financial or otherwise, substantial changes nearly always emerge. We believe this time will be no different and that a “new financial order” is in the process of emerging. While it is far too early to know with substantial certainty what this new order will look like, in our view, the key components of this new financial order will include:

Less Leverage for Both Companies and Consumers: In the financial world we have already seen that the old investment banking model (e.g., Goldman Sachs and Morgan Stanley) has disappeared and been replaced with a lower leverage commercial banking model. In the face of paying a substantial price in terms of their own financial security, we anticipate that consumers also will deleverage their personal balance sheets and that savings rates in the U.S. will begin to grow for the first time in years.

Re-pricing of Risk: Borrowers with poor credit, both corporate and personal, will find it difficult to get loans under favorable terms in the future. While these stricter credit standards will remove liquidity from the system and contribute to a slower growth model than we have seen in the past, this must be viewed as a positive development over the longer term as it removes risk from the system.

Greater Liquidity: Investors will reevaluate the notion of getting locked into longer-term investments such as illiquid hedge funds, private equity, etc.

Greater Transparency: Investors will likely demand greater disclosure before they commit capital to investments in the future. The Financial Accounting Standards Board has already published volumes of new rules, now under review, which will create unprecedented disclosure throughout the investment industry. In addition, we anticipate systematic changes such as a new clearinghouse for Over the Counter derivatives to provide a market clearing pricing model.

Increased Regulation and Oversight: Under a new congress and administration, new regulations, implemented by fewer government agencies, will likely emerge over the near term. Secretary of the Treasury Paulson outlined such a plan in March 2008 after the demise of Bear Stearns, but well before the financial crisis hit its crescendo in September and October. However, while additional regulation is needed, overreaching and unduly restrictive regulation can have a negative effect on economic growth and investors' willingness and ability to take appropriate risks.

[The Silver Lining — New Opportunities Emerge](#)

Every cloud has a silver lining and the current financial crisis is no exception. We believe that several investment themes have emerged from recent events, created by distortions in, and the overreaction of, the financial markets. How long these distortions will remain in place, and whether and to what extent they may expand before they contract, remains somewhat unclear at this time. Some of these distortions will not dissipate as the new financial order develops, while others represent a rare opportunity to capture extreme valuation distortions while fear and panic remain fresh in the investor psyche and uncertainty continues to loom over the financial markets.

We have all just lived through a very emotionally and financially disruptive period. The good news for our clients is that the diversification in their portfolios has somewhat mitigated market declines and prevented permanent impairment of their investment capital which will ultimately recover in time. Our role as stewards of our clients' wealth is not to be overly reactive to near-term events, but to continue to act logically and dispassionately in managing our clients' portfolios over the long term.

We are looking beyond the disruptive events of the past month and are focused upon capitalizing on these distortions to best position our clients' portfolios for the future. As such, we continue to carefully study the fallout of the recent market declines and the potential opportunities which have emerged. We also continue to analyze potential opportunities which have been created by the unprecedented federal infusion of capital into the financial system. We are in the process of better articulating these themes internally and identifying potential investments within each area. In the coming weeks, we will issue another commentary discussing these themes and how to potentially capitalize on them.

While it may be difficult to remain upbeat in these trying financial times, you should take comfort in knowing that the entire team at MDE is working tirelessly to ensure that you remain financially secure and on track to meet your long-term financial objectives. As always, we thank you for your loyalty and support. It is during these trying times that we continue to earn our reputation as *your family's most trusted advisor*.