



# Memo

To: MDE Clients & Friends  
From: The MDE Group, Inc.  
Date: March 5, 2009  
Re: It's Hard to be Optimistic – Even for an Optimist

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## **It's Hard to be Optimistic – Even for an Optimist**

### Changing Tactics for Changing Times

Until the past week or so, we were comfortable with the manner in which our clients' portfolios were positioned. As we have noted in previous correspondence, we entered 2009 with the lowest equity commitment and highest cash position in MDE history. Our clients' portfolios were rounded out by a large allocation to alternative and hybrid investments which have preserved capital quite well to date. In total, these portfolios were designed to cushion most of the market downside, while allowing continued market exposure in the event of a market reversal in which markets have historically retraced considerable ground over a matter of days. We had earlier outlined plans to begin reinvesting our cash cushion once we received some clarity of policy from the administration. Our plan was to dollar cost average our cash cushion into a combination of new and existing alternative and higher yielding hybrid investments to allow for additional return generation vehicles as the markets stuttered toward a recovery. However, due to the continued uncertainty surrounding policy responses, and the market's negative reaction to them, we have been extremely reluctant to commit cash to any investments. To date, we have been rewarded for this judgment.

We are pleased that our clients' portfolios in the aggregate have, in large part, performed as expected to date. In the face of the 22.5% YTD decline in the S&P through March 3, including the worst January and February on record, in the aggregate our client portfolios have preserved more than two thirds of the market decline during this period. Most of this decline is attributed to our remaining equity exposure. In general, this would be a reasonable price to pay in order to participate in a potential market recovery. However, in light of recent events, and for reasons discussed in detail below, we are questioning even our diminished level of exposure to equities in general, and specifically to some of our more aggressive managers who were left in the portfolio to take advantage of a potential market rebound.

We do not think we should react emotionally and further liquidate equities in the face of this downward market spiral. While we are continuously monitoring the markets and acting more tactically than we have in the past, we remain strategic investors, not day traders. For strategic investors, the overreaction of a 100% cash position is never a good long term solution since re-entry into the markets is perhaps the most difficult of all judgments. However, just as we did in December, we will look for a bear market rally to further reduce equity exposure — this time in favor of hybrids, alternatives and some high quality corporate fixed income. That said, we will continue to delay the implementation of any planned

investment into preferred securities, as well as higher yielding foreign sovereign debt, until we have more clarity. We will retain our cash cushion over the near term to protect against continued market uncertainty. However, we will retain a degree of equity exposure since we are not clairvoyant and hold out the possibility that the economy will show signs of life and the markets will begin to discount this recovery well in advance of that time.

Our rationale for this tactical repositioning, as well as our view of the current environment, is discussed at length below.

## Hope and Change

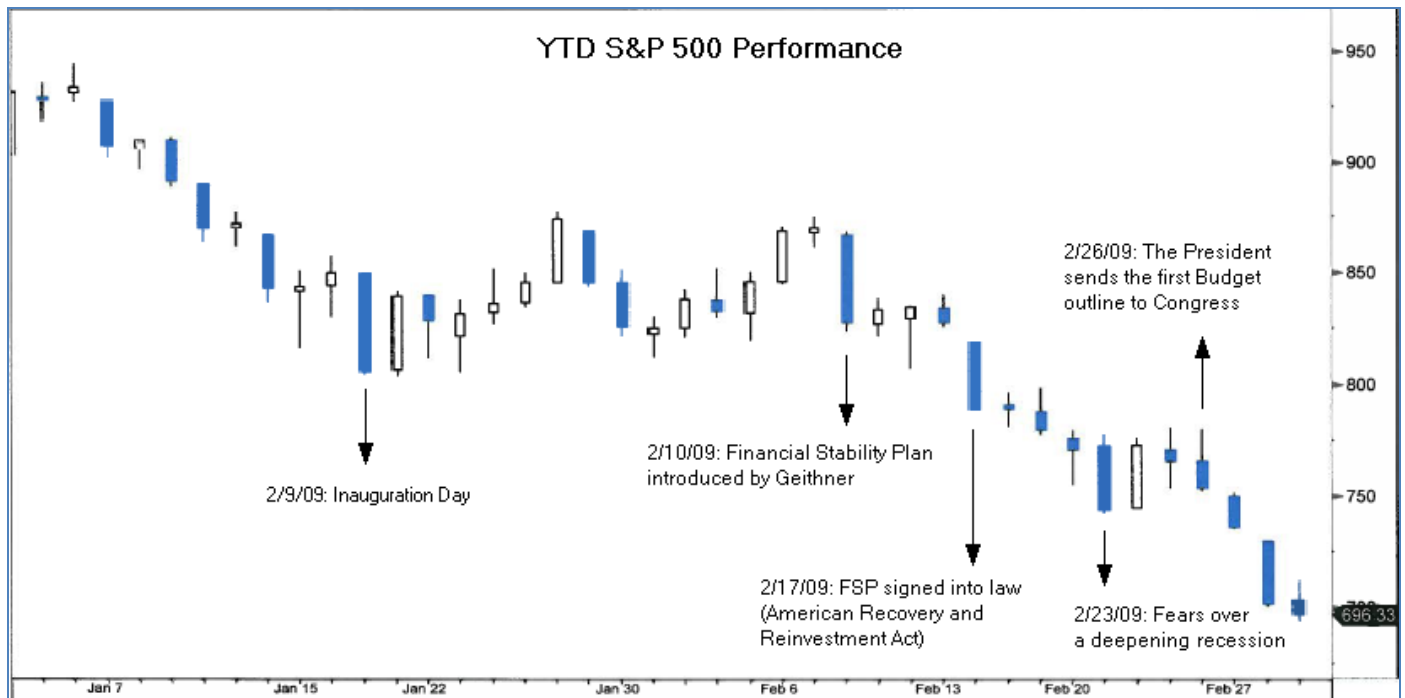
There is an old tale about the optimist who walks into a room and sees a pile of manure on the floor. The optimist asks, “where is the pony?” The others in the room ask what he means. The Optimist replies, “with all this manure in the room, there must be a pony around here somewhere.” Confronted with the biggest pile of financial manure they have seen in their lifetimes, investors today are assiduously looking for that pony, but it seems to be nowhere to be found. Coming off a horrific 2008, investors started the new year with an air of optimism. As should be the case after a national election, the country rallied around our new young President and administration — anxious for the hope and change they would bring to Washington.

Investors all understood the severity of the once in a lifetime financial crisis which confronted our country, as well as the rest of the free market world. Most realized there would be no quick fix. However, markets discount future events. After rallying to 935 on January 6, in the face of the leadership vacuum during the waning days of the prior administration, the S&P 500 made a near term bottom of 805 on inauguration day, January 20. However, for the next fourteen trading days the S&P 500 exhibited hope that positive change was in the offering as it rallied to 870 while investors awaited specific policy responses which would set the U.S. on a path to financial recovery.

This brief honeymoon period came to an abrupt end on February 10. Since then, the S&P 500 has lost nearly 20% through March 3, crashing through several important technical levels. While the President remains personally popular with the American people, the markets have been far less enthusiastic about each successive policy pronouncement which has come out of the administration. Markets have expressed their collective opinion by declining on a consistent basis to levels not seen since 1996.

## Markets Respond to Government Policy

Our current economic malaise, i.e. sluggish consumer spending, falling home prices, a clogged and weakened banking system, as well as growing unemployment, were a long time in the making and not easily solvable. The markets are realistic and do not expect any new administration to solve such complex and intertwined problem in its first five to six weeks in office. Markets understand that economies have several engines of growth which can lead them out of troubled times; i.e. consumer spending, new investment, monetary stimulus, and government spending, coupled with effective policy to create an environment which fosters growth in the future. In the case of our current situation, consumer spending and investments are declining. Unprecedented levels of liquidity have already been pumped into the system by the Fed and must be given time to work. While free market economies loathe to look to the government for help, when all else fails, the economy looks to the government as a source of fiscal stimulus for a near term catalyst. However, since markets are always forward looking, they look for long term policy solutions that will create a favorable environment for long term growth.



[Note: Blue color represents down days, clear color represents up days. Vertical lines reflect the daily trading ranges.]

At the root of our economic problems are the twin sided challenges of a weakened banking system caused by plummeting home prices. In a press conference on February 9, the President elevated the country's expectations that a solution to the former would be forthcoming when Secretary of the Treasury Geithner set forth his financial stability plan for the banking system the following day. As reflected in the chart above, markets started their current slide on February 10 when Secretary Geithner disappointed the markets with a broad outline of a plan which lacked detail.

Markets can effectively digest both good news and bad news, but they despise uncertainty. In response, the markets declined 4.9% on February 10 since they did not see a clear road map as to how the root cause of our financial crisis, i.e. the dysfunctional banking system, would be cured. However, the markets held out hope that the forthcoming stimulus bill would provide the economy with the much needed near term capital investment. Markets were promised infrastructure projects that would stop the current economic slide by reversing the downward trend in unemployment. However, it was broadly perceived that this unprecedented \$800 billion stimulus bill lacked sufficient near term stimulus, in the form of infrastructure and other private sector job creation programs, to have a material near term impact on the economy. It was almost universally conceded that most of the spending was directed toward social policy initiatives which, while perhaps worthy, only served to add to an already burgeoning deficit, without the desired stimulative effects. In response to this perception, the markets declined another 4.5% on February 17, the day the President signed this bill into law.

The next day the President announced a plan to provide much needed relief to the troubled housing industry — the root causes of the banking crisis. Most economists agree that the economic downturn will not stop unless and until housing prices stop falling. On February 18, the President announced another \$75 billion for housing support and foreclosure prevention. This plan was met with a populist backlash as many of those 92% of homeowners who were current on their mortgages questioned the morality of providing relief to the 8% who may have purchased more home than they could afford.

Rather than reacting enthusiastically to a plan that promised to put a floor under housing prices, the markets traded down modestly over the next four days, culminating in a 3.5% slide on February 23 in response to fears over a deepening recession. The markets rebounded on February 24, perhaps in anticipation to the President's address that evening to the Joint Session of Congress. Although the President gave an eloquent and inspirational speech, the markets failed to rally the next day in reaction as they awaited his forthcoming budget. That budget outline was delivered to Congress on February 26 which triggered yet additional declines.

In addition to reactions to policy, there also have been intervening macro and micro economic events which damaged investor psyche. On February 27, the government announced a downward revision in Q4 2008 GDP growth to -6%. On the policy front, that same morning the government also announced that it would potentially convert its preferred stock in Citigroup to a 38% ownership interest in common stock. The downward slide continued into March with AIG announcing a Q4 2008 loss of \$61.7 billion accompanied by the government's response of pumping yet another \$30 billion into this ailing company. These dual events, coupled with reaction to the budget outline, led the S&P to decline by another 7.5% to 696, its lowest close since October 28, 1996.

### What if There is No Pony?

While market optimists keep looking for that pony, they only seem to find an ever increasing pile of manure with no pony in sight. In the face of continued poor economic news, markets have been repeatedly disappointed by the lack of cohesive and focused policy responses from Washington to effectively deal with the worst financial crisis in our lifetimes. That said, with all the liquidity pumped into the system by the Fed and the unprecedented, albeit not sufficiently focused fiscal stimulus, we believe the economy will eventually find its bottom and begin its road to recovery, although perhaps not as soon as most would hope. If history follows true to form, the stock market will begin to discount this economic turn some six to nine months in advance. However, over the past several days markets may be looking through this potential economic bottoming to the strength and sustainability of any recovery in light of the President's recently released budget.

Not only is this budget unprecedented in size, it is equally unprecedented in its scope. While there is legitimate disagreement from different constituencies over the policy goals outlined in the budget, there is wide spread agreement that *now* may not be the time to tackle such ambitious plans — all at the same time. To quote a former president's inaugural address, "...our funds are low. We have a deficit to bring down. We have more Will than wallet; but Will is what we need." While no one can discern the exact cause behind market responses, there appears to be much concern that we simply cannot afford most of the policy initiatives outlined in the budget since there is much to do over the near term to solve our current financial woes.

As reflected by the market reactions to the attempted policy responses to date, the markets are skeptical, at best, as to their efficacy. Markets are still awaiting a comprehensive and detailed roadmap to solve the banking crisis so banks will begin loaning money in the coming months. In addition, markets seem to be extremely troubled by the perceived "anti-growth" initiatives proposed in the budget. These are not targeted and temporary, but will create a permanent shift of power from the private sector to Washington which will survive this President. In attempting to deal with some of the perceived shortcomings in our systems, markets view this budget as overreaching and potentially undermining the core strengths that have made the U.S. economy the envy of the world for nearly a century. Markets

further perceive that if fully implemented, this budget will hamstring our economy with large deficits for as far as the eye can see while limiting the growth potential inherent in our economy. There may have been an additional indication of this concern as interest rates on ten year Treasury bonds rose to near 3% during February in the face of a rapidly declining market which would have generally triggered lower rates in a flight to quality.

In spite of the emotional roller coaster the markets have created, we all know that equity markets will not go to zero. While no one knows for sure, markets are probably getting close to a bottom given the historically unprecedented distance traveled over a mere sixteen months since the October 2007 highs. In general, markets reach a bottom when emotions reach a point of maximum despair. For anyone watching the financial news of late, it certainly seems as if investors are reaching this point. In addition, we are confident that the liquidity pumped into the economy by the Fed and the stimulus bill will find its way into the system in the coming months and serve to stem the decline in the economy. We even believe that the Treasury will ultimately bring our banking system into equilibrium, albeit not as elegantly and quickly as we would have hoped.

That said, the reaction of the markets over the days since the presentation of the budget, have caused us to question whether and when we will find the pony. Until the announcement of the President's budget last week, we remained the optimist. We continued to believe that while the recovery may be slow and arduous, it would ultimately come and lead the financial markets back to higher highs in the years to come. We continued to believe that the American system of capitalism was ultimately self correcting and would find a new way forward as it has in the face of numerous crises, financial and otherwise, over the past 230 years. However, in regard to this final point, our confidence has been shaken as we believe has been the confidence of the markets.

### **There Must be a Pony Out There Somewhere**

While we are concerned about the potential anti-growth effect of some of the proposed policy changes, we understand that this country has a resiliency that has been unmatched in the world since our founding. We have experienced many challenges as well as shifting policy trends over the past century. When in the midst of a crisis of historic proportions, mere mortals suffer from the inability to see a clear way forward. In the face of varied and numerous challenges and near term reactions to the policies of the day, the greatness of this country is that it has always adapted and risen above all obstacles placed in our path and collectively discovered the way forward, albeit often by trial and error. We hope our country will do so again and that we are wrong relative to the long term effects of proposed policy changes. Given the greatness of our country, we like to continue to believe that there must be a pony out there somewhere.

However, given what we have seen over the past three weeks, we believe that rapidly changing times require us to be nimble and flexible. We will continue to be focused on asset preservation while preserving upside potential once the market presents us with a near term rally. To the extent we make changes, we will promptly communicate them and the potential effect on our client portfolios.

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*.