



MEMO

The Global Market Correction and Risk First™ Investing

The Problem: Too Much Debt; Not Enough Growth

August 8, 2011

To: MDE Clients & Friends

From: The MDE Investment Committee

Over the past several weeks, many of the risks we have highlighted over the past 18-24 months have begun to manifest themselves. In our Risk List, which we publish quarterly, we have consistently ranked the burgeoning federal debt as the greatest risk we face over the long term and have consistently ranked the European sovereign debt crisis, in the Top 5. After years of profligate spending and a lack of political will to deal with these structural problems, over the past month these issues have been brought to a head both at home and in Europe.

Our domestic problems are more fixable than Europe's given that we are a single country with a single currency. However, as reflected in the dysfunction that Washington exhibited over the past several months, it is clear that both parties remain intransigent and prefer to wage a partisan battle in the 2012 elections rather than do what needs to be done now to restore fiscal stability. This brought a strong, but not wholly unexpected, rebuke from Standard and Poors (S&P) on Friday evening August 5th, in the form of an unprecedented downgrade of U.S. debt from AAA to AA+. The downgrade, issued hours after markets closed on Friday, is a first for the U.S. since it was granted an AAA rating in 1917.

Although we anticipate some heightened volatility over the near term, the intermediate to longer-term effects remain somewhat unclear. While we anticipate modestly higher borrowing rates will follow, further weakening an otherwise tepid recovery and threatening a double dip recession, other effects are far from conclusive. The only good news in this situation is that our problems are imminently fixable if our politicians show the leadership they were elected to provide and act for the benefit of the country, not merely for the benefit of the next election. A strong dose of entitlement reform, coupled



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with a major tax simplification to broaden the tax base and raise more revenue, while providing pro growth incentives, could cure our problems in a decade. However, unless the Standard and Poors downgrade provides Washington with a wakeup call, we may have to wait until 2013 for any real reforms.

In further respect to the downgrade, if history is a guide, when Japan and Canada lost their AAA ratings, the initial reaction was negative, but rates stabilized within months. For example, when Canada was downgraded in 1994, its interest rates briefly went up by half a percentage point. A mere two months later, rates had come back down to where they were before the downgrade. In 2002, Canada ultimately reacquired its AAA rating after enacting a series of reforms. Japan lost its AAA status in November of 1998, resulting in its 10-year bond yield surging from 1% to 2.6% by early 2000. Ultimately, the weak fundamentals of the Japanese economy resulted in yields falling to 0.6% by late 2001. The Japanese example illustrates a AA rating still indicates a high likelihood to repay debt, but that the biggest driver of bond yields is the performance of the economy.

While these examples are instructive, they are not necessarily predictive since the U.S.' status as the world's reserve currency may be in doubt over the intermediate to long term. The only saving grace is that no other currency stands ready to take its place given the tenuous European debt situation and the fact that the Chinese Yuan is not a tradable currency and is years, if not decades, away from playing a part in this role. However, we may now be on an irreversible path to where a basket of currencies will ultimately assume this role and the U.S. Dollar will lose its vaunted status as the reserve currency. In the meantime, Gold, a speculative investment used as a safe haven during times of panic and currency crises, is shining at a record price of \$1,700 per ounce for the first time. If there is a silver lining here, it is that the Dollar will continue to weaken and this could help our export-oriented firms to stimulate growth. However, a weaker Dollar means higher commodity prices, higher inflation, and potentially lower standards of living for Americans. Furthermore, foreign investors may find Dollar denominated assets, such as U.S. Treasuries, less attractive.

The problems in Europe are a greater immediate threat to the worldwide economy since, if not contained, they could pose a liquidity crisis perhaps greater than that of Lehman Brothers. The contagion of over leverage continues to spread around the southern part of the continent with Italy, the world's eighth largest economy, now in the cross hairs. Spain, the twelfth largest economy, may follow. The European Union seems determined



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to prevent the further expansion of these problems given the dire consequences that would spread like wild fire throughout the worldwide banking system if any country, especially one the size of Italy, were allowed to default. However, given the nature of the Euro zone, with disparate economies, cultures and political problems weakly bound together only by a unified currency, their options are limited as they continue to float more debt and play "extend and pretend" in the hope that time will ultimately heal their problems. In some respects, their hand has been forced into this tenuous strategy since many European banks would be insolvent with another substantial write-down on the heels of the Credit Crisis of 2007-2009. Furthermore, the more stable countries funding the bailout, such as Germany, may ultimately reach a breaking point with respect to their largesse.

Although the full extent of the market decline is unknown at this time, it is worthwhile to note that virtually every major creditor of the U.S. Treasury, including large holders such as China and Japan, have come out in support of the safety of U.S. debt. G-7 members also issued a statement of cooperation the willingness to enact appropriate measures to ensure market stability. Investing legend, Warren Buffett, said he believed U.S. Treasuries deserved a "quadruple A" rating. Furthermore, the two other major rating agencies, Moody's and Fitch, continue to rate U.S. Treasury debt AAA. The "split" nature of the ratings, (S&P vs. Moody's and Fitch) may not result in mandatory selling for those investors or funds that are obligated to hold only AAA rated debt.

RISK FIRST™ INVESTING SUBSTANTIALLY MITIGATES MARKET LOSSES

While we have always said we cannot know the unknowable or predict the unpredictable, coming out of the 2007-2009 market meltdown, it became obvious to us that the structural problems facing the U.S. and the rest of the developed world would not allow us to return to the outsized growth patterns that we enjoyed during the 1980s, the 1990s and even the mid 2000s. We coined the phrase "New Market Realities" to describe a long-term period of slow growth and heightened volatility, punctuated by periodic crisis. Rather than chase market returns, we adopted a Risk First™ approach that would allow us to participate in market rallies, albeit not to the same extent as the market beyond a certain level, in exchange for substantially mitigating losses in down markets and avoiding large holes from which it is difficult to recover.

During each quarter of 2011, markets have been faced with periods of correction, the most substantial and recent one having started on July 7th. In the first quarter, the S&P suffered a correction of 6.3% from February 18th to March 16th. During that time, MDE



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accounts declined an average of 1.5%, only participating in 24% of the market's decline. Likewise, in the second quarter, markets suffered a 6.9% decline from April 29th to June 15th. Again, during this time MDE accounts declined an average of 1.8% or only a 26% participation in the market decline.

During this most recent decline from July 7th through it's near-term lows on August 5th, the S&P 500 declined by 11.3% (declines extended to 15% on an intraday basis, as of Monday morning), while MDE's average account declined by only 3.1% or a 27% participation. All MDE clients have customized asset allocations reflecting their specific goals and objectives so individual client performance will vary. However, by way of illustration, MDE's best performing account increased by 1.7% during this period while our worst performing account declined by 10.6%. On a year to date basis, the S&P is down 3.6% through August 5th while the MDE composite is up 1.0% and the average MDE account is flat. The range of MDE account performance on a year to date basis is -6.5% to +12.2%. The wide range of returns during the recent drawdown period, as well as on a year to date basis not only reflects customized asset allocations, but significant cash flows both into and out of accounts during these periods. If you would like to review your specific account performance, please contact your wealth counselor. In addition to mitigating actual losses, MDE's average monthly volatility in 2011 has been 2.89% compared with 8.01% for the S&P, indicating a 64% risk reduction.

CONCLUSION

As in all aspects of life, there is never a free lunch in investing. To protect from the downside, we cannot fully participate in market upsides. Likewise, to allow reasonable upside participation, protection levels will be greater in markets that decline more gradually. All that said, we continue to believe that our Risk First™ approach is the best solution for our clients in what we continue to perceive as an environment of New Market Realities. Our goal in this environment is not to beat the market to the upside, but rather to provide you with stability, consistency, and peace of mind.

As always, we close by thanking you for your loyalty and support. We at MDE consider our relationship with our clients a symbiotic partnership. We realize our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at MDE is focused on individual and collective improvements each day.



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