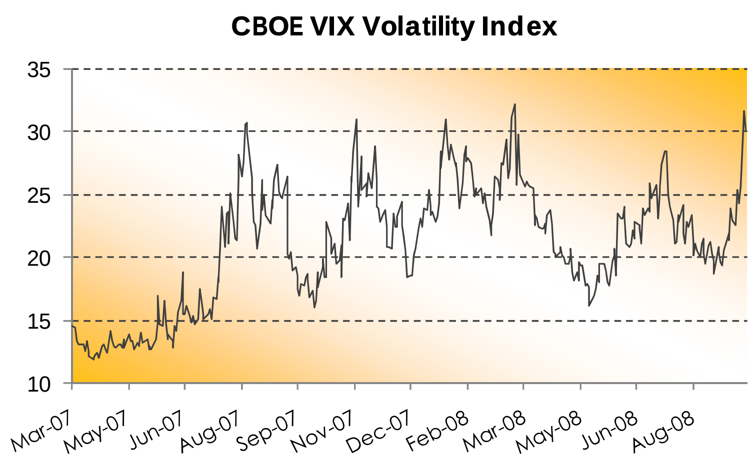
Ac-Cent-Tchu-Ate the Positive

Recently, one of our colleagues said to us, "Can't you guys tell me something good? Your market view is depressing me. Is water still flowing downhill? Tell me the world as we know it is not coming to an end."

While we stand by our concerns, we agree that hearing negative news day after day gets depressing. So, it was our intention this month to publish a research piece discussing what we believe are the long-term positives for the markets, the proverbial light at the end of the tunnel. Then the day we have grown to dread in the markets, Sunday, came along once again with a serious challenge for our positive attitudes. After the bankruptcy and fire sale of two prominent investment banks, with the country's largest insurer hanging by a thread, it seemed like it would be difficult to put on those rose colored glasses. On the contrary, though, these events have given us hope.



Markets trade on expectations, and the more uncertainty surrounding those expectations the more fear and instability we see in markets. In his 1933 inaugural address, FDR tried to reassure Americans ravaged by the Great Depression that "the only thing we have to fear is fear itself." While fear itself may not be the only problem we have in today's markets, it is a big driver of the volatility and lack of direction we see. As we move through each step of the crisis, we gain more information and eliminate some of the unknowns. We now have the federal government's explicit guarantee of Freddie Mac and Fannie Mae, and we no longer need to speculate on what could happen if an investment bank fails. We are still certainly in the grips of a credit drought with interest rates rising and spreads widening, but despite this the Federal Reserve reconfirmed their inflation-fighting resolve. They held the fed funds target rate steady at their policy meeting this week, and continue to rely on other more explicit mechanisms to inject liquidity into the markets. All of these developments may not bring short-term relief, but we believe they are setting the stage for a sustainable recovery in the months to come. **We believe that the recent chain of events may be the roadmap to navigate our way out of the tunnel, even if we are not quite yet approaching the light.** Here we focus on the positive developments we see on the horizon, and how we can use the lessons learned in this crisis to become even more skilled and prudent investors.

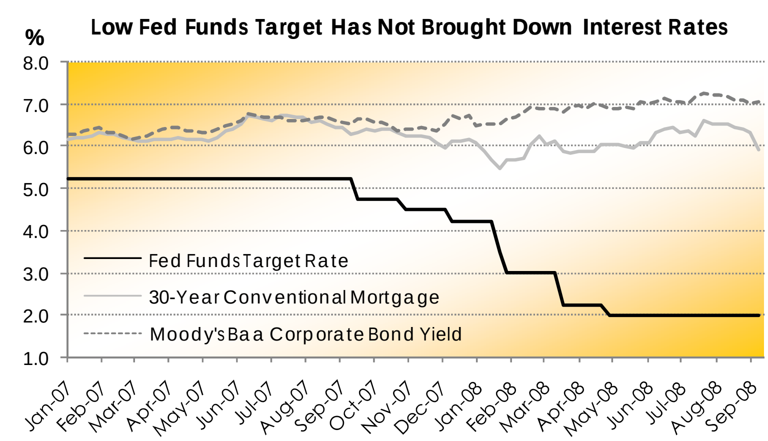
A Return to Risk Awareness & Transparency

In recent years, the models used by analysts to construct complex derivative instruments and assess risk seemed to follow the adage "what goes up, never comes down." The housing crisis has been much maligned and fingers pointed at the inexplicable fact that prices have fallen. This was not "supposed" to happen, and neither the under-qualified borrowers nor the financial professionals dressing up risky debt in AAA clothing incorporated this possibility. Investors across the sophistication spectrum are guilty of ignoring downside potential in exchange for a little more return. It has been a brutal lesson, but it will refocus both professional and individual investors on determining their actual exposure to catastrophic risk. The unfolding of this crisis only serves to reconfirm that the risk/reward tradeoff is alive and well, and in fact what goes up, sometimes does come down.

At MMA, we often shake our heads that the financial industry is one of the few in which people will pay more for something they do not understand. Opaque methodologies may have helped banks pass along expensive structured products to clients, but this lack of transparency contributed to the severity of the crisis as these products crashed. At Lehman, the lack of transparency potentially cost them a firm-saving buy out as Barclays found themselves unable to accurately assess the level of toxic assets on the balance sheet. As Wall Street eventually makes its way back across the pendulum from fear to greed, we hope that risk awareness, greater transparency and sensitivity analysis will remain priorities for investors as it is for us at Miracle Mile Advisors.

Continued Vigilance Against Inflation

We believe that the decision to hold rates steady at this week's Federal Reserve FOMC meeting was a prudent one. Thus far, a low federal funds target rate has not done much to ease other interest rates. Mortgage rates have remained high, easing only when the Treasury announced its decision to seize control of Freddie Mac and Fannie Mae. It is unlikely that lowering rates further would now stimulate credit markets gripped by risk aversion, but they would likely set the stage for inflation worries down the road. Sustained low real interest rates fueled the current crisis, and repeating these mistakes will not undo the past. The Fed has other mechanisms at work to inject liquidity into the banking system and ensure that institutions have access to liquidity.



Source: Board of Governors of the Federal Reserve System

Despite the credit crisis, global inflation forces remain threatening. Price increases are sticky, and increased costs from high oil and commodity prices earlier this year will continue to feed through to consumer goods for months to come. While growth in emerging markets has slowed, it is still robust in absolute terms. As the rest of the world slows, namely the U.S. and Europe, the Chinese are taking steps to stimulate domestic demand. After years of following an inflation-fighting policy, the Chinese Politburo decided at the end of July to shift its priorities. Its economic goals are now to first sustain economic development, and second to limit inflation. Last week China eased rates, and also reduced the reserve requirement ratio for small- and medium-sized banks. Our structural view is that the growing middle class societies of emerging Asia and India will continue to fuel demand for scarce commodities, stimulating long-term global growth. We expect inflation to remain a front-burner issue for years to come, and it is important that the U.S. Federal Reserve show signs of hawkishness now to avoid letting prices get out of control. We favor maintaining holdings in gold and inflation-protected securities to hedge against the forces of inflation.

Lifestyle Downsizing

Americans are downsizing. Cars are shrinking and becoming more fuel efficient. McMansions with thousands of unnecessary square feet languish unwanted as people are forced to buy homes they can actually afford. Conservation and green living have gone main stream. Even the mega-grocery store is going by the wayside. Chains such as Safeway, Jewel-Osco and WalMart have opened or are planning to open smaller format stores in major metropolitan areas including southern California, Chicago and Phoenix. Research from Supermarketguru.com shows that the average American goes food shopping for only 22 minutes, and with limited time he is choosing simplicity over variety. Could it be that Americans are discovering bigger is not always better?

Every grandparent who grew up during the Depression has stories about saving, sharing and reusing precious goods. Many of us have seen them save things like sugar packets from restaurants, only to discover that there are hundreds of them in a kitchen cabinet at home. The instinct against waste was deeply instilled. We are not suggesting that our generation will be forced to wear hand me downs, but a trend toward living within our means is a positive step for a resource strapped world.

Attractive Emerging Market Valuations

We believe that the long-term global growth story will come from the emerging world, and right now these equity markets offer a cheap entry point. Credit-related risk aversion as well as political turmoil in Russia have brought emerging market equities down to a deep discount relative to the U.S. market. The MSCI Emerging Market index is now trading at about 9.8 times 12-month forward earnings, below even the level reached in 1998 during the Asian financial crisis. These countries are expected to grow at an average rate of 6.7% next year according to the IMF, presenting a very favorable risk/reward tradeoff. There may be more downside in the short run, but we feel strongly that over the next market cycle Emerging Market equities will be significantly higher than where they are today.

Benefits of Diversification

Almost everyone can rattle off the old investing premise of "buy low, sell high" but few put it into practice. In fact, many investors buy momentum (high) and sell panic (low). This strategy leads to a portfolio that is heavily weighted toward holdings that have already had their run, and underweighted in those with better value. By maintaining a disciplined rebalancing rule, simply trimming holdings that have done well and buying those that have not at a lower price, a portfolio will maintain its diversification. "Doubling down" on winning assets, as some did with oil at $145 or Lehman did last summer with mortgage backed derivatives, can end up a very costly bet if the trend reverses.

The single stock risk exhibited in the past year is a good reminder of the dangers of being insufficiently diversified. While a year-to-date (Sept. 15) price return of -18.8% for the S&P 500 may not leave you jumping for joy, it is much better than the single holding returns of Freddie Mac (in which shareholders were wiped out), Washington Mutual (-85.1%), or even a market stalwart like GE (-32.3%). The losses suffered by Lehman and Bear Stearns employees holding large portions of their wealth in company stock serve as another warning against concentrated stock risk, particularly for retirement assets.

Despite the losses experienced in global equity markets, we maintain some exposure in our portfolios. There may be another leg down to come, but accurately timing an inflection point is impossible. As we saw in the market rally after the Treasury announced its willingness to back Freddie Mac and Fannie Mae in mid-July, turnarounds happen swiftly and strongly. We recommend holding equities at reduced weightings to mitigate risk but maintain exposure.

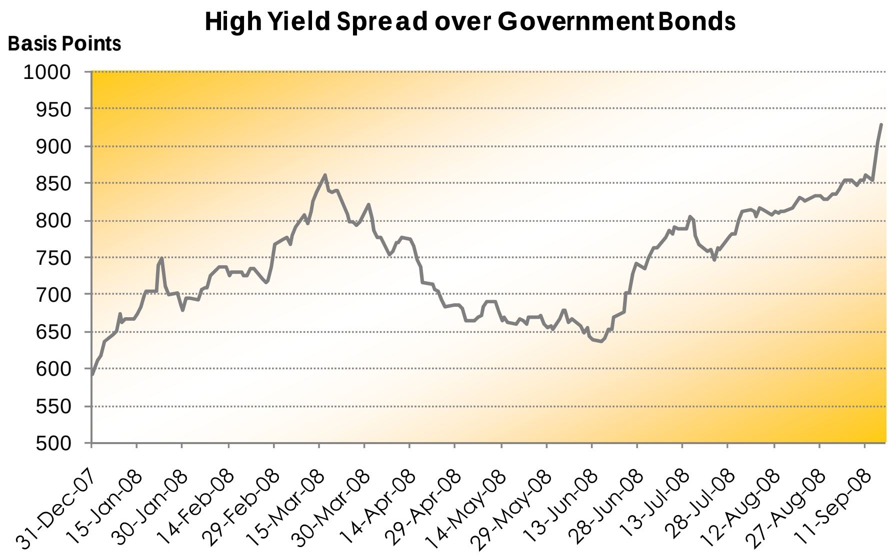
Investment Horizon = Performance Horizon

If you are a long term investor, it is unproductive and frustrating to watch the day to day gyrations of the markets. With daily swings often exceeding 2% or even 3%, investors have been on a rollercoaster with no brakes. **Your performance horizon should match your investment horizon**, so long term investors should focus more on annual and full market cycle returns to assess their investment strategies. If in fact you are a short-horizon investor who requires near-term liquidity, then it is always advisable to maintain a higher cash allocation.

As an example, look at the difference between the standard deviations of daily returns and monthly returns of the S&P 500. Since the beginning of 2003, the standard deviation for daily data is 14.4%, while for monthly it is 9.8%. Remember that these numbers reflect the same underlying return. Over time, short-run fluctuations are smoothed over and the underlying trend is revealed.

Conclusions

In the grips of the current market turmoil it is difficult to maintain a long-term outlook, but this is the most important time to do so. Panic selling near market bottoms is what ultimately makes for capitulation, but those "go with the herd" sellers end up losing on both the downside and the rebound. Legendary banker Baron Rothschild has been attributed as saying that the best time to buy is when there is "blood in the streets, even if the blood is your own." This contrarian call advises long-term investors to look forward in times of maximum pessimism, resist the urge to run for the exits, and view it as a buying opportunity.



Source: Merrill Lynch, Option Adjusted Spread

We are not calling a market bottom yet. As we write this, mega-insurer AIG is in the midst of a meltdown, likely to be sold off piece by piece to repay a loan of $85 billion from the Federal Reserve. Other institutions are assessing their exposures to Lehman Brothers and AIG. Questions remain about the sustainable independence of the remaining Wall Street investment banks, and it is likely that more regional banks will fail. Fear is still the predominant force in the markets, and our much watched credit spreads are spiking higher, not retreating. We are looking for some easing in spreads as a signal that the most severe risk aversion has subsided. When we feel that risk appetite is sustainable, we will start to slowly rebuild our equity positions. Until then, we maintain half positions in developed equity markets with a much larger than normal exposure to cash and short-term Treasurys.

September 17, 2008

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