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Market continues its losing ways, or does it?

Quarterly Newsletter
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The first quarter of 2008 marked one of the worst quarters in history. The S&P extended its losing streak to five consecutive months, the longest such streak since 1990. The financial system was in turmoil. More large write offs at financial institutions are expected. Housing appears still in a crisis. Credit markets have been dysfunctional. Consumer spending is down. Food and gas prices are up. Manufacturing is down. Unemployment is up. The country of Iceland faces a run on their currency. Bear Sterns was brought down by a loss of confidence in their ability to meet their obligations, and by short selling. And yet, on the first day of the new quarter, the market was Dow was up 391 points as financial stocks soared after UBS and Deutsche Bank wrote off $23 Billion dollars. Bad news was truly good news.

The quarter was marked by extreme volatility. Many days saw swings of 100 points or even 200 points in both directions. It was no time for the faint of heart. If all the problems from housing and credit markets were not enough, extreme panic set in when it was determined that a rogue trader at Societe Generale was responsible for billions in losses for that bank. First the markets in Europe plunged, followed by the U.S. and Asia. The Federal Reserve acted with force, slashing rates in an intermeeting rate cut, even though a scheduled meeting was only days away. Then the Fed slashed rates even more at their scheduled meeting. They poured money into the system and made dollars available to their counter parties in Europe, but they received scant aid from the European Central Bank.

In December the Fed unleashed a veritable alphabet soup of new programs to aid the financial sector, but the emergence of the rogue trader seemed to undue their good work. The global financial system seemed poised on the brink so heroic measures were required.

But that was not to be the end, as a run on the bank at Bear Stearns once again brought financial markets to a standstill and we once again looked into the abyss. Depression loomed. Bear, the fifth largest investment banking firm in the U.S. was brought to its knees by rumors that it could not meet its commitments and that bankruptcy was imminent. Perhaps some of these rumors were promulgated by short sellers wishing to make a profit. Perhaps there was some truth. No one who went to work on that Monday at Bear could have foreseen that by Friday the firm would be history. Vast fortunes were lost. The stock price which had been over $100 at the start of the year fell so far that when a deal was brokered by the Fed between J.P. Morgan and Bear, the price paid was $2.00 per share. (Later raised to $10.00 per share.) The entire firm was valued at $1 Billion, which is about the value of their real estate holdings.

Ben Bernanke, perhaps the leading student of the Great Depression, knew that we stood on the brink and did not want a repeat. He reached back to the Depression for lessons, and tools. He also created new tools never before seen, nor perhaps even imagined, a few days before. These were truly days that changed capitalism.

In the days that followed the Fed working with the Treasury Secretary, Henry Paulson, former CEO of Goldman Sachs, unveiled a bewildering array of plans for the economy. The plans promised something for everyone from homeowners to Wall Street. All eyes are on the government to see what will be done for homeowners, now that Bear Sterns and Wall Street have been cared for. Even President Bush, normally an advocate of free markets has suggested doing much more for homeowners, even guaranteeing underwater loans.

In my column for the Daily Journal of Commerce last month I suggested that the Fed was moving toward nationalizing the home loan problem, and days later that is what they did by agreeing to accept home loans as collateral for loans from banks. No act of congress was needed. To take further steps will in many cases, require congressional action, and with just ten months left in the current President's term, action will be difficult to come by.

As you know, we began eliminating financial stocks from portfolios last year, followed by consumer discretionary stocks. We became more defensive in general. This strategy served us well last year where we had strong performance relative to the market. This quarter's results have been different. We have been down as the market has been down, but our defensive posture has left us vulnerable to up markets, and indeed on up days we have underperformed the markets. So on down days we have generally done better than the markets, but on up days we have underperformed. Because there have been several days or periods with large gains, we have found ourselves still at the starting gate with cash and defensive holdings. While we have tried to protect your portfolios, that has come at a price. It is not that we are doing poorly; it is that we have not done as well on good days. There will be quarters when we underperform, but we know that we out perform more often than not, and we have been able to do so over time. Your questions and comments are always invited.

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