MARYLAND CAPITAL ADVISORS INC.
◊ SEC-Registered Investment Advisory ◊

INVESTMENT COMMENT — November 17, 2008
Perspective, Policy Responses and Investment Implications

Following a tough 3rd Quarter, the month of October was even worse for investors holding anything other than US Treasury obligations. Global capital markets have become extremely volatile as each day brings news of corporate and banking turmoil and corresponding global government and central bank reactions. Global equity markets, as measured by the MSCI World Index posted the worst single month return (-18.9%) since inception of that index in January 1970. US equities, as measured by the S&P 500 Index, were -16.8% in October – the 9th lowest return since 1926.

The last few months have been a volatile cocktail of political rhetoric, economic and regulatory policy changes, and unprecedented monetary policy actions from global central banks. As global investors across various asset classes, we require an understanding of these actions along with an appreciation for the historical context of capital market reactions. First, let us review how various elements of our globally-diversified, balanced portfolios have fared, and then we will compare broad market performance with history. We will follow with a review of the current environment and specific investment implications.

As shown in the accompanying table, non-Bond asset classes were hit especially hard in October. The only asset class with positive returns was 1-3 year US Treasury Notes (+1.1%). This down draft has been so severe that even investors with balanced portfolios have suffered dearly. A simple U.S.-centric portfolio of 60% stock market exposure has now lost more than 25% year-to-date (Vanguard 60/40), while a globally-diversified portfolio with the same percentage of equity risk is down over 29% (DFA 60/40). Such 60/40 portfolios have now lost about 3 years of appreciation.

Selected Asset Classes November 14, 2008	YTD Return	Oct Return
EQUITIES		
US Large Cap Core	**-40.2%**	**-17.5%**
US Large Cap Value	**-39.5%**	**-17.3%**
US Small Cap Core	**-39.7%**	**-20.8%**
US Small Cap Value	**-36.0%**	**-20.0%**
Large Cap International	**-46.5%**	**-20.8%**
Emerging Markets	**-55.2%**	**-25.6%**
ALTERNATIVES		
International Real Estate	**-54.4%**	**-25.3%**
US REITs	**-47.9%**	**-31.3%**
Commodities	**-31.9%**	**-21.3%**
BONDS		
US Treasuries 1-3yr	**+5.3%**	**+1.1%**
US Treasuries 7-10yr	**+6.8%**	**-0.9%**
US Treasury Inflation-Protected	**- 4.3%**	**-8.1%**
Mortgage-Backed (MBS)	**+3.4%**	**-1.5%**
International (Non-US Dollar)	**-7.3%**	**-5.8%**
EQUITY INDICES		
MSCI World Index	**-43.2%**	**-18.9%**
S&P 500 Index	**-39.3%**	**-16.8%**
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	**-25.9%**	**-11.6%**
DFA 60/40 Fund	**-29.6%**	**-13.2%**

Source: Bloomberg Professional
Note: Returns include reinvested dividends.

What happened? Continued de-leveraging – forced sales by investment funds needing to repay borrowed funds in addition to October's typical mutual fund selling related to October 31 fiscal year-end. Investor redemptions were also substantial, which required further selling. In this environment, there was little benefit to diversification among non-bond assets – all risk asset classes were "for sale". This selling hit a market already fragile due to diminished confidence in the global financial system.

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As asset allocating investors, it is important to recall that long-term diversifying benefits of many asset classes may not always be apparent in times of wide-spread selling of all risk assets. Although markets continue to have a great deal of "fear" priced-in, there are opportunities developing. Demand for short-dated US Treasuries has been so strong that the yield on 1-month T-Bills is almost zero. Conversely, yields on investment-grade corporate bonds are now offering attractive compensation for investors. ***For the first time since we began managing client portfolios, we are introducing a corporate bond allocation to client portfolios.*** The size and method of adding this exposure to each portfolio varies by client and will be discussed directly.

So, "how bad is this?" For historical perspective, the adjoining table illustrates the 10 worst peak-to-trough moves in the S&P 500 Index since 1927. At this point, the current down-cycle began October 11 last year and has generated a -41.4% return to this past Thursday's market close. This is bad enough to rank as the 6th worst period ever. ***Clearly equity market returns have been bad, but not without precedent.*** The 1929-1932 period stands-out in history as the worst ever. We have all read media reports wondering aloud if the current situation may evolve into a 1929-1932 market, followed by economic depression. In fact, in a measure of current pessimism, one recent survey found 59% of respondents said a depression was "somewhat" to "very" likely[1].

Historical Perspective Peak-to-Trough Market Declines	Total Return	Years
Sep 16, 1929 – Jun 1, 1932	-86.2%	2.7
Mar 10, 1937 – Mar 31, 1938	-54.5%	1.1
Jan 11, 1973 – Oct 3, 1974	-48.2%	1.7
Mar 24, 2000 – Oct 10, 2002	-47.4%	2.5
Nov 9, 1938 – April 28, 1942	-45.8%	3.5
Oct 11, 2007 – Nov 13, 2008	-41.4%	1.1
Nov 29, 1968 – May 26, 1970	-36.1%	1.5
Aug 25, 1987 – Oct 20, 1987	-29.7%	0.2
Dec 12, 1961 – Jun 26, 1962	-28.0%	0.5
Nov 28, 1980 – Aug 9, 1982	-26.6%	1.7

Source: MCA, Bloomberg, using S&P 500 Index

Indeed, the over-use of financial leverage that caused asset bubbles is a shared causal factor between the 2007-2008 and 1929-1932 periods. However, ***policy responsiveness and the developed structure of our financial system are far different and argue for an outcome quite unlike the Great Depression***. Our August 2007 articles on the subject highlighted both the seriousness of the developing crisis as well as the observation that "…The Fed clearly knows what it is doing and is working in an incremental fashion to resolve the issue…"[2] Looking back, that was an understatement, as the Fed has since initiated a barrage of programs targeted at preventing a financial system liquidity crisis as occurred in 1929. Ben Bernanke, himself a student of the Great Depression[3], is well-aware of what economists refer to as a "liquidity trap" – a condition that exists when interest-rates at or near zero are unable to stimulate economic activity. For that reason, he has encouraged Congress to enact further fiscal spending measures[4]. In fact, we will likely hear more about a "Zero Interest Rate Policy" as the Fed is now more concerned with fighting deflation than targeting the short-term Federal Funds rate[5]. ***What does this mean for investors? We can expect further interest-rate cuts in the U.S. and abroad.***

Policy tools being used are targeted at two fundamental aspects of the crisis: liquidity and solvency. Federal Reserve policies are targeted at promoting financial system liquidity, while the US Treasury, Congress, and regulators have grappled with solvency matters. We intend to adhere to the age-old advice not to discuss politics with friends, but as investors concerned with the implications of policy responses, we need to, at a minimum, understand a material change to Treasury's Troubled Assets Relief Plan ("TARP") announced this past Friday.

Recall that TARP's original intent was to purchase structured securities from financial institutions at current distressed prices. As indicated in our client email at the time, Treasury is uniquely positioned to make such investments *profitably*. No other financial institution can issue debt at US Treasury rates around 4% or less and purchase asset pools at prices that yield much higher returns. We saw this plan as a direct means of cleansing financial firm balance sheets while leaving solvent, albeit smaller, institutions to get on with the business of lending. One concern we raised then was: "What if TARP is ultimately profitable? Might Congress want to expand government investment funds into other aspects of markets?! Let us hope they stick to the business of fixing the regulatory regime while TARP resolves the crisis at-hand".

On Friday, Treasury Secretary Paulson stated that the Capital Purchase Program (CPP) announced one month ago is a more effective policy than asset purchases – Treasury has now abandoned the original plan. The CPP program, using TARP capital, purchases Senior Preferred Stock in any approved bank or thrift and receives warrants to purchase common stock. This may well work, but since the "troubled assets" remain in the system, one concern is that banks receiving this capital infusion will hold dear (they may not lend) their new cash to ensure their future solvency. Already we have heard Congressional ranting that participating financial institutions must lend any money raised from "taxpayer funding"[6] Under the original TARP methodology, the US Treasury would have simply owned assets purchased from financial institutions. Now, the Treasury owns equity stakes in an expanding number of US financial firms. To the extent that Congress becomes a collection of activist-owners, rather than policy-makers focused on much-needed regulatory modernization, corporate management will be needlessly distracted from real business – which will impede the recovery. As a former colleague quipped last week on a conference call, our financial system is moving along a business model continuum from "Las Vegas" toward the "Department of Motor Vehicles". ***The process is unnerving, but regulatory middle-ground will be found.***

The bottom-line for investors? Equity markets have discounted a large amount of uncertainty that is nearly as bad as every single peak-to-trough cycle except for the 1929-1932 period – when policy-makers were slow to respond. It is clear that policy-makers around the globe are unanimous in their continued resolve to react with fiscal and monetary stimulus. There is no historical precedent for such intervention not working and, in fact, it is reasonable to expect a collective over-reaction which could reignite inflation fears in years to come. When markets sense that reality, stock prices will discount expected earnings (rather than fear near-term insolvency) and move higher. US Treasury yields will rise to reflect lower "flight to quality" demand and increased Treasury borrowing needs, and risk-balanced portfolios will benefit from a return to normal return correlations among asset classes. It is a question of "when" this will happen, not "if". In the interim, we remain committed to the process of rebalancing risks to targets, minimizing after-tax costs through tax-loss harvesting, and selecting prudent bond investments to maximize the fixed-income portion of our portfolios.

[1] CNNMoney.com, October 6, 2008, money.cnn.com/2008/10/06/news/economy/depression_poll/
[2] "A Crisis of Confidence in Money Markets", August 21, 2007, www.marylandcapitaladvisors.com
[3] See, for example, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression", The American Economic Review, Vol. 73, No. 3 (June 1983), pp. 257-276
[4] October 20, 2008 speech before the Committee on the Budget, US House of Representatives
[5] Remarks by Ben Bernanke before the National Economists Club, "Deflation: Making Sure 'It' Doesn't Happen Here", November 21, 2002 http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm
[6] Barney Frank, House Financial Services Committee, as quoted on MarketWatch, October 31, 2008

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