MARYLAND CAPITAL ADVISORS INC.

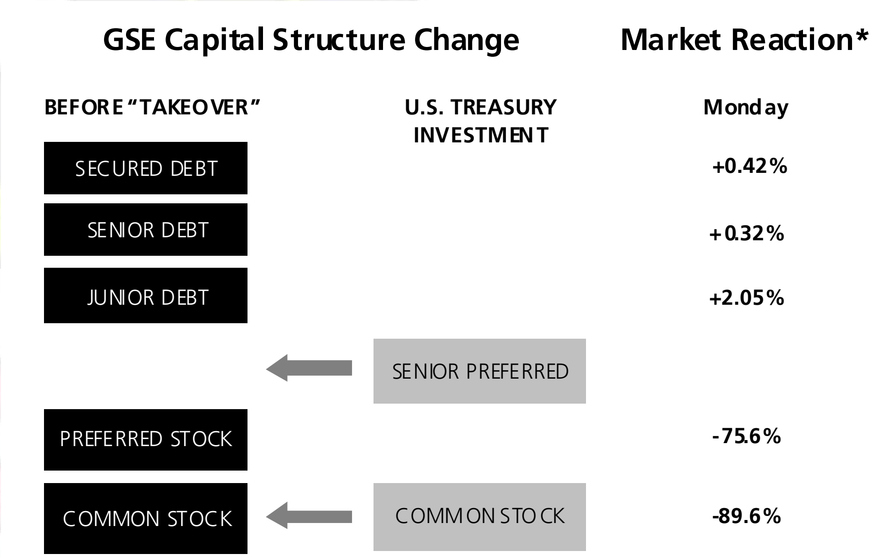
◊ SEC-Registered Investment Advisory ◊

INVESTMENT COMMENT **September 14, 2008**

Lessons from Freddie Mac and Fannie Mae Conservatorship

Since last weekend's "takeover" of Fannie Mae and Freddie Mac[1], investors have borne the impact of this decision across various classes of securities. In particular, common stock and preferred shares of these government-sponsored entities (GSEs) were, essentially, wiped-out. $9.5 Billion of market value was lost by common shareholders and approximately $380 million[2] by preferred shareholders from Friday to Monday's market close.

Recall that Treasury's investment of up to $100 Billion in each GSE will be in the form of new preferred securities, plus an option to purchase new common stock that dilutes current shareholders to 20.1% ownership. The chart (right) shows the priority of claim on GSE assets from top to bottom. This illustrates the liability-side of the balance sheet and shows how the Treasury's senior preferred essentially demoted the claim on assets of existing preferred and common stock-holders. As demonstrated by the market reaction on the first trading day after the announcement, common and preferred shareholders did not anticipate such an action at all (-89.6% and -75.6%, respectively). Debt holders' claims on GSE assets were unaffected and prices rallied on news of Treasury's Plan.



** Selected GSE debt and preferred benchmarks*

No one, not the Fed, Treasury, Wall Street analysts, or anyone else knows what the asset-side of the GSE – or almost any other financial firm – balance sheets are worth. Financial firm balance sheets are very complex and the lack-of-transparency in how assets are valued has compounded the problem. Additionally, demand for such financial assets was driven by firms that leveraged their investments heavily with borrowed money. As we continue the de-leveraging process, there are more sellers than buyers of assets. Merrill Lynch set the tone in June, when it decided to value over $30 Billion of its balance sheet (collateralized debt obligations or CDOs) at 36 cents on the dollar. At the end of July, they sold these same CDOs 40% lower in price (22 cents). ***Given the uncertainty of asset values, and the fact that many firms have yet to "mark-to-reality", investors had better understand "Capital Structure 101". Owning concentrated positions in common and preferred securities is not a prudent portfolio strategy.***

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An important lesson for investors is that some portfolio investments may have similar cash flow characteristics, but significantly different risk – and these risks must be understood, allocated, and managed accordingly. ***Preferred stock, for example, is widely-held by many investors as a bond-like instrument although it clearly falls below debt in balance sheet hierarchy.*** In the event of liquidation, proceeds from the sale of assets first repay debt, then preferred stock, then common stock. ***Our client portfolios have not had an allocation to preferred stock and very limited preferred exposure from fund investments.*** Should we determine such an investment improves a portfolio, we may establish a prudent exposure. Our asset allocation process separates the many bond-like risks as much as possible. ***We generally utilize individual US Treasury Notes or funds with narrowly-defined investment parameters to ensure that we can monitor and manage each bond risk independently.***

Investors with global portfolios structured to be asset class diverse have not avoided negative equity market returns year-to-date. Actively-managed stock-pickers – managers that could actually reduce stock risk or even sell-short stocks – did not fare better and, in some cases, much worse. ***We remain committed to our diversified strategy as a long-term approach to earning the global capital markets return, without bearing single-stock risk.***

Passive Portfolios vs. Active Funds	Return YTD	Return 1 Year	1-Year Risk
Passively-Managed 60/40 Funds			
Vanguard 60/40 Allocation (ticker: VBINX)	-6.5%	-5.5%	8.0
DFA 60/40 Allocation (ticker: DGSIX)	-9.3%	-9.3%	8.7
Popular Market Indices			
Dow Jones Industrial Average	-12.1%	-12.6%	13.7
S&P 500 Index	-13.3%	-13.9%	13.7
MSCI World Equity Index	-17.5%	-15.9%	
Selected Actively-Managed Funds			
Legg Mason Value Trust	-32.4%	-36.8%	19.3
Blackrock Global Allocation	-9.9%	-4.6%	9.0
Morgan Stanley Strategist	-8.6%	-6.8%	9.5
UBS Global Allocation	-12.1%	-11.8%	10.4

Source: Bloomberg L.P.
Note: Returns are calculated inclusive of reinvested dividends.
Risk is standard deviation of returns.
Index risk and return are calculated using tradeable, index-equivalent ETFs

While there have been many investment funds hurt by concentrated positions in GSEs and other financial company stocks, there is now a larger concern for banks with significant holdings in GSE preferred stock. Over the next 60-90 days we will learn from bank earnings and write-down announcements the extent of such exposure, but some analysts have begun naming names based on current regulatory filings[3]. As I write this, the NY Fed is announcing a broadening and expansion of their funding facilities for banks and brokerage firms – the seriousness of this deleveraging process is not lost on policymakers.

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[1] See MCA Investment Comment September 7, 2008 on our website.
[2] MCA calculations of actively-traded GSE preferred shares
[3] Exhibit 3, page 3, Goldman Sachs research, "United States: Banks", September 7, 2008.

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