MISSION
MANAGEMENT & TRUST CO.

QUARTERLY COMMENTARY

Third Quarter 2008

September 30 seems so long ago. While this is our report on the third quarter, so much has transpired over the past few weeks that it demands comment.

Let us start with the third quarter. The S&P 500 was down by 8.4%; the Lehman Brothers Aggregate Bond Index, the broadest measure of investment grade bonds, was down by 0.5%; three-month U.S. Treasury bills rose by 0.4%. Other than in risk-free securities, there was no place to hide. In that context, losing just a small amount of money was a moral victory and a far better result than achieved by nearly all other investment managers.

Over a 40-year investment career, however, I have learned not to be satisfied with moral victories. You can't spend relative performance, only absolute performance. That leaves me with mixed feelings about both the third quarter and the twelve months ending in September. Over that longer period, the S&P 500 declined by 22%. During that very difficult year, our stock holdings were just about flat, which enabled us to earn a positive return of a few percent for all of our Controlled-Risk Flexible Allocation portfolios, the strategy that most of our clients have asked us to employ.

A down year became somewhat of a disaster for most investors as the calendar turned to the fourth quarter. In the first eight business days of this month through October 10, the S&P 500 declined by an additional 22.7%, bringing the equity market's decline for the preceding twelve months to more than 40%. Fear was in the air, as unanswered questions swirled around the nearly paralyzed credit markets. The country of Iceland was skating on the brink of bankruptcy. Yields on three-month U.S. Treasury bills dropped to just above zero. Investors were eager to let the U.S. Government hold their money for three months for essentially no return. This was the quintessential example of investors' concern with the return "of" their money rather than the return "on" their money.

As clients know, we conduct seminars in February and October to supplement our annual client conference in April. There was so much concern about the securities markets that the number of registrants for this October's seminar forced us into a larger meeting room at the host hotel. We reminded guests that fully a decade ago we had not only forecasted a major collapse of stock prices in the years ahead, we accurately pointed to the reasons for the coming decline as well.

In 1997, more than two years before the equity markets peaked, we highlighted the unsustainable nature of the U.S. debt condition. We warned repeatedly over ensuing years that the leverage being employed by individuals, businesses and government would ultimately lead to a bad result. As derivative volumes exploded, we debunked the argument that these were merely financial instruments for prudent hedging. On the contrary, we regularly reminded clients of Warren Buffett's characterization of derivatives as "financial weapons of mass destruction." We now know, to the world's chagrin, that debt and derivatives have been the crumbling pillars that have undercut the stability of our economy and our securities markets.

Again, more than a decade ago, we began to warn that equity valuations had reached absurd, unprecedented levels. At presentation after presentation we stressed that, while valuations were a poor short-term indicator, at extremes they had never failed to identify the areas of major stock market tops and bottoms. We made the point repeatedly that the only reasons then for owning large levels of common stock were that either: 1) you would sell that stock before it started to decline or 2) the market itself would never again decline below then prevailing levels. Since most major stock market averages are now back to 1997 price levels, the only winners were successful timers who exited most stock positions before they started to plummet. Throughout history, the buy and hold approach after periods of extreme overvaluation has led to losses for extended periods, sometimes lasting more than a decade. We have argued instead for strategic allocation that reduces risk when valuation ratios are historically high and assumes more risk when those ratios are historically low. That approach has enabled our clients to make money consistently through the difficult years of the past decade.

On a fundamental basis, investors are faced with greater uncertainty than ever before in our lifetimes. Our governmental and monetary authorities are nationalizing large segments of the American economy: first the banks and selected insurance companies, next the auto industry and who knows what may follow. Those authorities argue that to do anything less would be to risk the collapse of the financial system as we know it. If their expressed concerns are realistic, the prospect for common stocks is murky at best. Of course, the proposed rescue efforts may succeed. They may prevent a serious recession and revive our economy. Corporate profits may grow, and stock prices may climb. Maybe; maybe not.

Much of what is being attempted is unprecedented. The authorities leading the rescue effort didn’t see the problem a year ago. Intermittently through subsequent months they assured us that the problems were contained and that the economy would soon be humming along smoothly. On what reasonable basis should we now have confidence in their calming assurances? Neither they nor we know whether the rescue effort will succeed. We do not mean to imply that they will not succeed, just that the probability of their success is unknowable.

At a lesser level, that macro uncertainty casts into question the predictability of corporate earnings. If the credit crunch does not ease appreciably and soon, forecasts of corporate earnings are not much more than guesses. We issue strong cautions to both our individual and institutional readers.

Individuals have been conditioned by almost unrelentingly rising securities markets through the decades of the 1980’s and 1990’s to believe that being “in it for the long run” negates the need to do periodic strategic asset allocation. In an environment in which the world’s monetary authorities are warning about the potential collapse of our financial system, you are risking major portions of your invested assets if you simply accept the traditional, relatively fixed asset allocation approach of the big bank trust departments.

Institutional investors have been heavily influenced in recent years by their consultants and by the success of many types of alternative investments to diversify their asset allocations. We have argued for the past few years that the success of many of the hedge fund and private equity ventures has been more a function of heavy leverage in a rising asset price environment than a reflection of investment genius. We expect the collapse of a great many hedge funds and private equity firms as the availability of liquidity dries up to all but the most credit-worthy borrowers. Some firms with many years of great performance have died suddenly. There will be many more.

In this highly uncertain environment, characterized by dramatic price swings, we are keeping a stable portion of our portfolios earning a government guaranteed return. We add to equities when prices decline sufficiently and sell equities when prices rise appreciably. We remain alert to react quickly to important changes in the credit environment and the securities markets. In a highly unstable time period, we lean toward caution, but we remain ready to act when prices decline to attractive levels.

To understand the importance of day-to-day vigilance, one need only examine the stock market action of the past few weeks. In the first few minutes of Friday, October 10, the Dow Jones Industrial Average traded below 7900. In the first few minutes of Tuesday, October 14, the widely-watched index traded just below 9800. In the span of two full market sessions, the average rose by about 24%. The Dow Industrials first reached the 7900 level in July 1997. It first rose to the 9800 area in March 1999. What took 20 months to cover a decade ago was traversed in just two full market trading sessions this month. When heretofore multi-year market moves now take place in just days, the take-your-time investment approach of the big bank investment committees is far from timely. At Mission, we evaluate each portfolio every day, and our process is prepared to take advantage on a daily basis of price moves that we used to expect only over the long term. In today's market, investors should expect nothing less.

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