

2008 First Quarter Asset Class Report

April 7, 2008

Global capital markets were marked by continued flight-from-risk in bonds and stocks in Q1. This effect was global – not just a US phenomenon. US stocks (-9.5%) were only marginally worse than rest-of-the-world equities (-8.9%) as the credit crisis affected financial institutions in Europe and Asia. The “technology” of asset securitization that allowed global investors to make leveraged investments in US financial assets, such as mortgages, consumer receivables, and pools of corporate credits was created in New York and London. However, as I described in our August 2007 articles¹, global investors relied heavily on the due-diligence of rating agencies and were significant purchasers of such securities². The impact of expected losses from these securitized bond investments forced huge revaluations of such holdings in Q1. One issue for investors to appreciate is that these valuations are imprecise, since the “market” for such securities is highly-leveraged and difficult to mark-to-market. In the current environment, prices for these securities are very likely to “over-shoot” (to the downside) their likely economic value. Whether or not this has already happened is unclear.

Equity Asset Class

In this uncertain environment, all equity asset classes had negative returns in Q1. **Small Cap Value (-6.8%)** performed best, while **Small Cap Growth (-13.1%)** was the worst. Along the academic factors of Growth-Value and Small-Large, Value was the most positive contribution to Q1 returns. *Our client portfolios have greater-than-market allocations toward Value and Small, to capture the long-term premium of these risk factors.*

US Equity Market Factor Returns

	Growth	Core	Value
Large Cap	-10.2%	-9.2%	-7.9%
Mid Cap	-11.0%	-9.5%	-8.6%
Small Cap	-13.1%	-9.9%	-6.8%

Source: MCA 2008 Q1 Asset Class Databank

Alternative Asset Class

Our client portfolios have important, long-term diversifying exposures to Real Estate and Commodities – we do *not* invest client capital in Hedge Funds. **US REITs (+0.2%)** was the only equity-like asset class with a positive return in Q1, while **International Real Estate (-6.7%)** was negative. **Commodities (+14.4%)** had the highest return of *all* asset classes. *Our allocations to these “non traditional” asset classes are strategic, rather than derived from short-term expectations. We doubt that any investor expected US REITs to outperform US equities by almost 10% in Q1 – further evidence that it is difficult to market-time investments.*

Fixed-Income Asset Class

The bond market has been the “tail” wagging the equity market “dog” since late-July 2007. In Q1, this flight-to-quality and un-winding of highly-leveraged bond investment strategies led to inferior returns for credit exposure (investment grade, High Yield, Emerging Markets). The lowest-returning asset class was **High Yield Floating-Rate (-3.3%)**, which underperformed **Treasuries 1-3yr (+3.0%)** by 6.3%. As previously explained³, *our client portfolios have had virtually no exposure to credit – the yield incentive offered to bear that risk had simply been too small. However, we may introduce some exposure to high grade bond funds in the near future, since there is now a reasonable yield premium offered above US Treasuries.*

To understand the extent to which the US Treasury bond market returns have been enhanced by fear-of-credit, investors need only review current yields. At quarter-end, the US Treasury

¹ See “Repricing Risk Due to Sub-Prime Mortgages and Leveraged Loans” August 6, 2007 and “A Crisis of Confidence in Money Markets” August 21, 2007 at www.marylandcapitaladvisors.com

² One friend and institutional portfolio manager noted that “bad mortgages are the #1 U.S. export”

³ See, for example, “2006 Fourth Quarter Asset Class Report”, www.marylandcapitaladvisors.com

10yr Note was priced to yield 3.41%. In normal circumstances, bond investors demand a yield premium that is in excess of current inflation expectations. Year-over-Year CPI is currently +4.0% -- US Treasury 10yr Notes have not yielded less than CPI since the 1973-75 and 1978-79 periods of "stagflation" (high inflation, stagnant economy). US Treasury yields have been driven to historic lows by credit risk-aversion, and can be expected to normalize and begin to fear inflation when the current credit crisis subsides. *We have managed the risk of higher interest rates by maintaining shorter average maturities in client bond portfolios – and will continue to do so.*

Treasury Inflation-Protected Securities, or **Treasury IPS (+5.3%)** had a strong Q1 due to "credit fear" demand for US Treasury debt and inflation fears fanned by the Federal Reserve's aggressive rate cuts. *Client portfolios have an "inflation hedge" component comprised of Commodities and Treasury IPS. To mitigate interest-rate risk (and minimize fees), however, we generally purchase individual US Treasury IPS bonds with maturities shorter than 5 years (most Treasury IPS funds have much longer average maturities).*

Lastly, note that Municipal bonds underperformed US Treasuries significantly (see chart). The credit crisis spread to the municipal market in Q1 as a result of significant credit stress at bond

Municipal vs. US Treasury Bond Returns

	Munis	Treasury	Spread
Short	+1.0%	+3.0%	-2.0%
Intermediate	-0.3%	+6.0%	-6.3%
Long	-1.5%	+3.8%	-5.3%

Source: MCA 2008 Q1 Asset Class Databank

insurers that provide third-party guarantees to many municipal bonds. Additionally, a common structure in the Muni market that involves bond interest rates established by frequent (often weekly) auctions, lost investor and dealer support. This auction-rate securities (ARS) market is large and no longer functioning properly. For investors comfortable with specific municipal credits, there are unprecedented market yields available.

In fact, AAA-rated 10yr Munis typically trade at yields equal to 80%-85% of fully-taxable US Treasury yields, but ended Q1 0.33% *higher* in yield – almost 110% of the US 10yr note yield⁴. *Our client portfolios generally do not hold bonds in taxable accounts and, therefore, client Muni allocations are modest or non-existent.* However, in client situations where we can not allocate all bond investments to tax-deferred accounts, a strong case can be made that the municipal bond sub-asset class offers substantial risk compensation and might warrant consideration. We have been reviewing this situation and evaluating the trade-off between Muni funds that typically have significant interest-rate risk and the opportunity in the Muni ARS market. We will likely be adding municipal bond exposure on a case-by-case basis to those taxable client accounts that would benefit on an after-tax basis from the current inverted pricing situation. This risk will not be appropriate for all client portfolios.

The 1st Quarter was challenging across many asset classes. For a review of our investment philosophy in the context of current market conditions, see "Update on our Passive, Asset Class Balanced Strategy" dated April 7, 2008.



[see MCA's 2008 Q1 Asset Class Databank]

⁴ Source: Moody's 10-Year AAA Index vs. US Treasury 10yr Note