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2008 3rd Quarter Review

The 3rd quarter marked continued weakness in the financial sector. Leading economic indicators turned down throughout the period. Although the major indices continued to weaken on a year to date basis, the MSAM Growth composite ended the quarter in much better condition than the broader market. Updated performance numbers are available on the MSAM website: <http://www.msam.net/products.htm>.

Steps we began taking in 2007 to address a weakening business cycle have continued to offer great flexibility in managing client portfolios. We've maintained higher portfolio cash levels and taken advantage of short term fear in the market while continuing to invest in longer term themes.

Current Observations

The credit crisis continues to top the news headlines. Although the government takeover of Fannie Mae and Freddie Mac in July likely took away the greatest risk as a result of the housing bubble, we have seen a lot more damage as financial leverage has been unwound in the financials. Although this cleansing process in the business cycle does not offer great feelings to us as investors, it is necessary to get rid of the excesses. Rather than recount the headlines, the important thing to note is that the governments of the world have intervened to recapitalize and put in place programs to shore up the financial system.

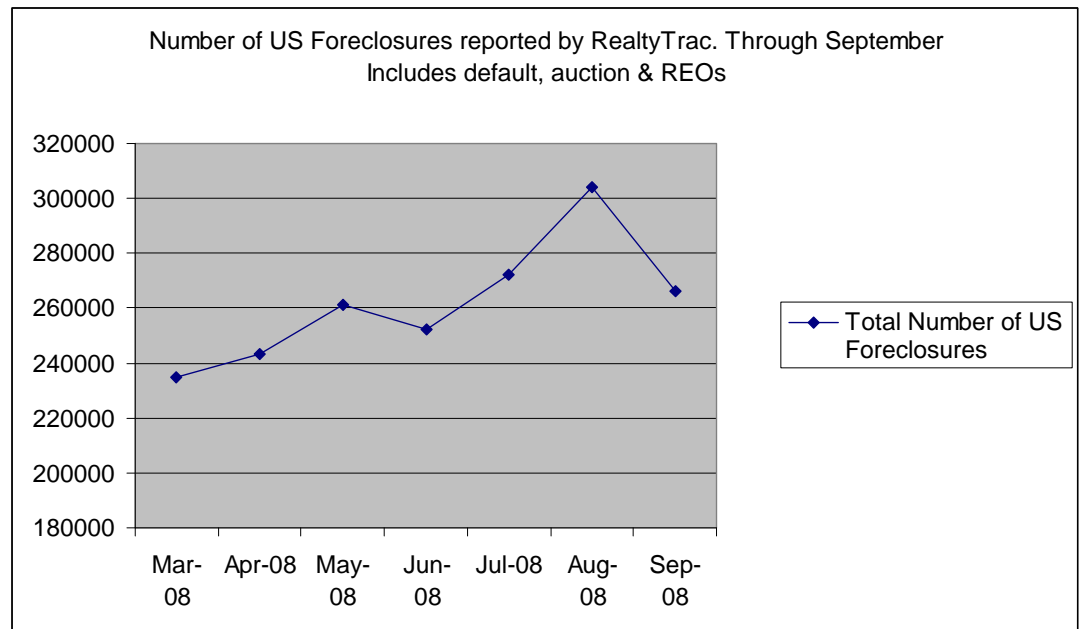
The U.S. government, in particular, has worked to lessen the magnitude of the recession and avoid anything remotely resembling a main street run on the banks. While some people have extrapolated that we face a situation like the banking crisis of the early 1930's, a look back to that time dispels the notion. In that era, as a result of the depression and failed government policies, people had lost confidence in the system. Banks were still on a gold standard. There was no FDIC. By 1933, in a run on the banks, people not only went to banks to get their cash out, but even wanted gold instead of currency. After a number of states had declared banking holidays, President Roosevelt, upon taking office in March 1933, declared a national bank holiday which lasted a few days. This marked the climax of the crisis. The stock markets were also closed for the bank holiday. To communicate with America, Roosevelt began making radio addresses called fireside chats, to reduce uncertainty and restore confidence. The first of these was delivered on Sunday, March 12th, 1933, to address the banking crisis. Here is an excerpt from Roosevelt's address:

“It is possible that when the banks resume a very few people who have not recovered from their fear may again begin withdrawals. Let me make it clear to you

that the banks will take care of all needs, except, of course, the hysterical demands of hoarders, and it is my belief that hoarding during the past week has become an exceedingly unfashionable pastime in every part of our nation. It needs no prophet to tell you that when the people find that they can get their money -- that they can get it when they want it for all legitimate purposes -- the phantom of fear will soon be laid. People will again be glad to have their money where it will be safely taken care of and where they can use it conveniently at any time. I can assure you, my friends, that it is safer to keep your money in a reopened bank than it is to keep it under the mattress.”

Roosevelt’s efforts were successful. The banks reopened and the equity market indices began to march higher. Many financial institution regulations, including the formation of the FDIC, came from that period. We clearly have some problems today and will need to fix some of those regulations. But, with 8,500 or so banks in the U.S., and only about 120 of them on the troubled bank list at the FDIC, it would seem to be quite a stretch to draw a parallel in the magnitude of the crisis today with the 1930’s.

Returning to current observations, we are beginning to see signs that the steps the government has taken are working. Beyond the many account guarantees extended to us by FDIC and the U.S. Treasury through the banks, in RealtyTrac’s recent foreclosure report, they show that the volume of foreclosures peaked in August, as can be seen in the chart below.



Source: Bloomberg, RealtyTrac

While August 2008 may not mark the absolute peak in the volume of foreclosures, we think the September data is encouraging. In recent testimony before congress, Sheila Bair, the chairwoman of the FDIC, spoke about some of the work they are doing. She offered the July closure of IndyMac, a California bank as an example. After the FDIC took over IndyMac, they suspended most of the foreclosures that were in process, sent out 7,000 offers to make loan modifications, and have received over 3,500 accepted modifications back thus far.

The work done there will likely become a template used to develop a broader government mortgage program, in conjunction with the recently passed legislation.

While these types of actions by the government don't instill a great deal of confidence in the majority of us who never got into this real estate mortgage malaise to begin with, we can look toward the market for some opportunity and reward. As a result of these actions, we are most likely seeing a floor put in for both the housing market and the broader economic weakness.

2008 4th Quarter Preview

“Weak, but not terminal” continues to describe the environment. With news that the 3rd quarter economic growth was negative along with a negative consumer spending quarter for the first time since 1991, we've finally begun to see the forming of a bottom in the business cycle. With that, the equity markets have sold off some 30% in September and October. This has created both a great deal of fear and opportunity. Much of the market chatter now, in late October, has shifted to a depression vs. recession conversation, rather than solely fear based, panic selling we saw earlier in the month. We have and will continue to take advantage of opportunities that selling has created.

The most important thing that we've been able to do this quarter is to work with many clients to break the negative feedback loop that down market indices, magnified by the press headlines creates. Professionals and lay people alike must deal with the emotion that short term events bring. But history has rewarded those who have been able to look beyond weakness over short periods of time. Being in a flexible position with a portfolio when weakness comes, looking forward with valuation work underneath buy and sell decisions, gives us the ability to lead with our money rather than simply react to short term events.

In fact, many of our clients have added to their accounts over the last quarter to take advantage of the fear, after initially dealing with that negative short term emotion. For example, one millionaire client called on a Friday afternoon late, concerned after talking with other acquaintances that were pulling their money out of their bank. With some perspective to allay that concern, the next week the client called back to work on increasing a percentage investment allocation in a 401k. Another client whose initial feeling was one of needing to be talked down off a ledge, later called unexpectedly to inform us that 2 checks were on the way to fund both a Roth IRA and a taxable brokerage account.

It has mattered not what level of sophistication or amount of money people have in their account. The need to overcome the short term emotions are the same. We look forward to continuing that dialog with all of our clients. While the next monthly statements that go out will not be pretty to look at, putting them in perspective gives us the opportunity to work together and help clients lead with their money.

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