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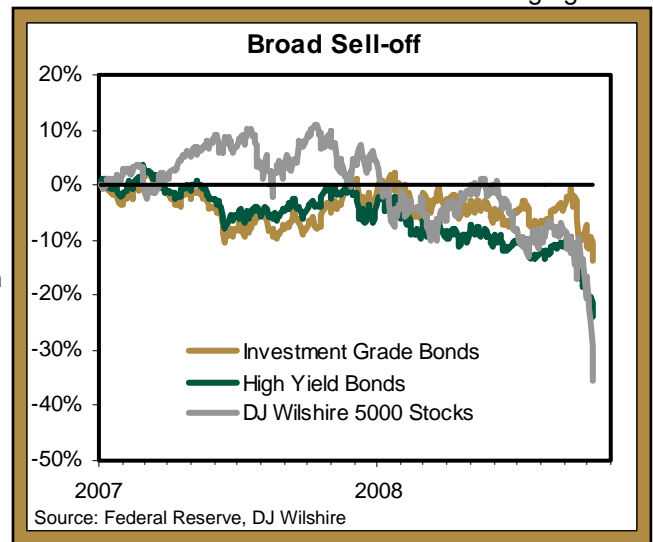
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## The Quarter in Review

Back in 2003, billionaire investor Warren Buffett referred to derivatives as “financial weapons of mass destruction.” Five years later we realize what he meant. The problems began with a decline in housing prices, which led to an even larger decline in the mortgage backed securities created by Wall Street Investment Banks. The damage caused by these mortgage derivative securities is large and growing, including a bankruptcy filing by Lehman Brothers, a government loan to AIG, and both Fannie Mae and Freddie Mac having to be placed into a conservatorship of the Federal Government. Washington Mutual Bank, Merrill Lynch and Wachovia Bank were forced into merging

with larger and more stable partners. As a result, investors worldwide are losing confidence in financial institutions. This is important for the ongoing concerns of all banks as they rely on the widespread perception that they are in good shape for the long term. A loss of confidence by customers can lead to a wave of withdrawals that reduces confidence and leads to more withdrawals and eventual failure. Compounding the problem at the banks is the fact that they have come to the realization that they are over leveraged and carry too much debt. They are selling

at the same time, and the glut of supply is driving prices down, which then reduces the value of the assets they still own. Even after reducing debt, their debt ratios are no better than before, so they continued to sell more debt at even lower prices. Many banks have had to raise capital by selling additional equity, which is dilutive to current shareholders and has caused the banks’ stock price to decline. This loss of confidence and de-leveraging by the banks has led to an unprecedented amount of selling and a significant decline in equity prices. Credit markets have become less liquid and, with the exception of treasury bonds, most bond prices have also declined. The selling accelerated in September, and into the first part of October, leaving the Dow Jones Industrial Average, the S&P 500 and the NASDAQ Composite down more than 35% for the year. Government intervention was welcomed and necessary to stop the decline.



## TARP

During the first week of October, Congress approved the \$700 billion Troubled Asset Relief Program, or TARP, in what is hoped to be a cure for the ailing U.S. capital markets. TARP uses the U.S. Treasury’s balance sheet to purchase distressed mortgage securities from banks and other financial institutions that otherwise cannot find buyers.

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*"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."*

Warren Buffett

The Treasury will purchase these assets above the current distressed market price, but still at a discount, so that the Treasury, and taxpayers, will be able to profit from these securities if they are held for a longer period of time. The idea behind TARP is to relieve banks of their troubled assets, allowing them to shore up balance sheets and to begin making new loans and investments providing much needed liquidity back into the financial system. Additional government intervention in the form of guaranteed deposits or equity stakes in financial institutions may prove to be necessary to stem the crisis.

### *A Historical Perspective*

In our last quarterly comments we noted that since 1940, investors have endured 11 bear markets. Over this time period the average bear market has lasted slightly over a year and produced a market decline of around 30%. By historical standards, we should be very close to saying goodbye to the Bear. We admit that the current credit crisis is significant and that, in hindsight, both the Treasury and The Federal Reserve were not as proactive as they should

have been. The speed with which the recent sell-off took place has caught us all by surprise. And while no one knows exactly when stocks will stop going down, there are tell-tale signs around us that the selling is overdone. A recent cover of *Time* magazine is titled The New Hard Times and shows a black & white photo of 1930's era men in a soup line. Historically, similar bearish news media covers have come near market bottoms. Fear levels have skyrocketed. Depositors are withdrawing money from their banks to place it under the mattress and many investors are choosing to sell stocks at already depressed levels. Commodity prices have declined sharply since spiking this summer but gold remains near an all time high as investors bid up the price of the only item they feel will retain any value. Panic selling has driven stock prices down to historically low levels, levels that usually lure bargain hunters. The S&P 500 trades around 10 times trailing earnings, well below its historical average of around 15.

Clearly economic growth is going to slow and most likely contract during the remainder of the year. The economic recovery that we had been hoping for in the second half of this year will have to wait until 2009 or later. The current credit crisis is real, but we will, with the help of government intervention, get through it and at some point begin growing our economy again. There is room for optimism, as stated by Vernon L. Smith, the winner of the Nobel Prize for Economics in 2002; "but there is good news: homes, stocks, crude oil, copper, corn, soybeans, wheat, lumber and even ethanol are now cheaper." We also note that the man who predicted this disaster, Warren Buffett, has been recently buying shares of stock in both Goldman Sachs and General Electric. It reminds us of another of his famous quotes; "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

S&P 500 Returns After Recession Lows			
S&P 500 low date during recession	S&P 500 gain (loss) after		
	3 months	6 months	12 months
June 13, 1949	14.5%	19.2%	33.7%
September 14, 1953	9.9	17.7	38.5
October 22, 1957	6.1	9.8	31.5
October 25, 1960	15.9	25.2	30.9
May 26, 1970	16.9	20.8	44.5
October 3, 1974	13.5	29.9	34.6
March 27, 1980	18.3	31.1	37.1
August 12, 1982	37.8	41.6	57.7
October 11, 1990	6.7	28.8	28.8
September 21, 2001	18.0	17.2	-13.7
Mean	15.8	24.1	32.4
Median	15.2	23.0	34.2

Source: Ned Davis Research