

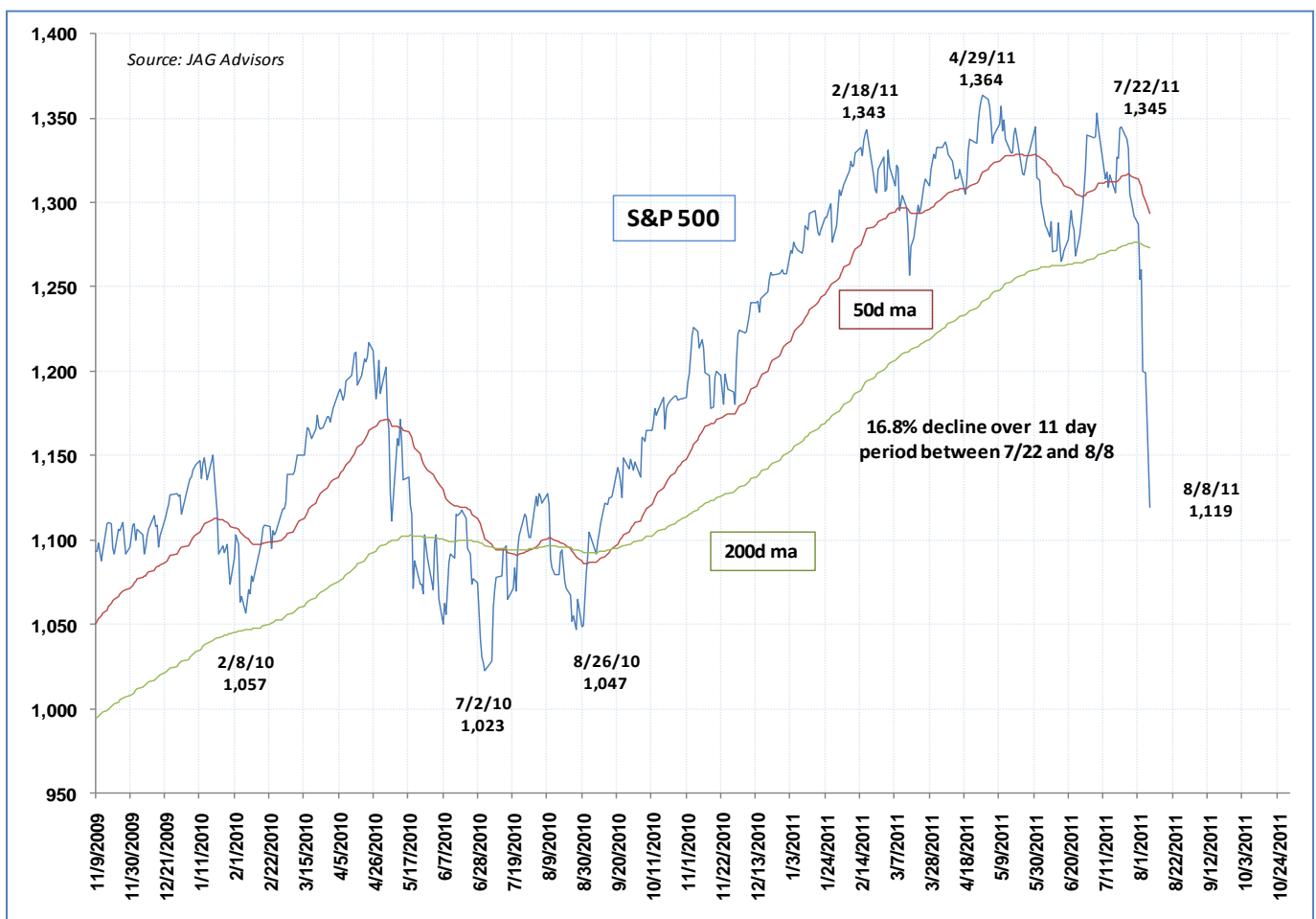


## Stock Market Turmoil, U.S. Debt Downgrade Implications, Etc. August 9, 2011

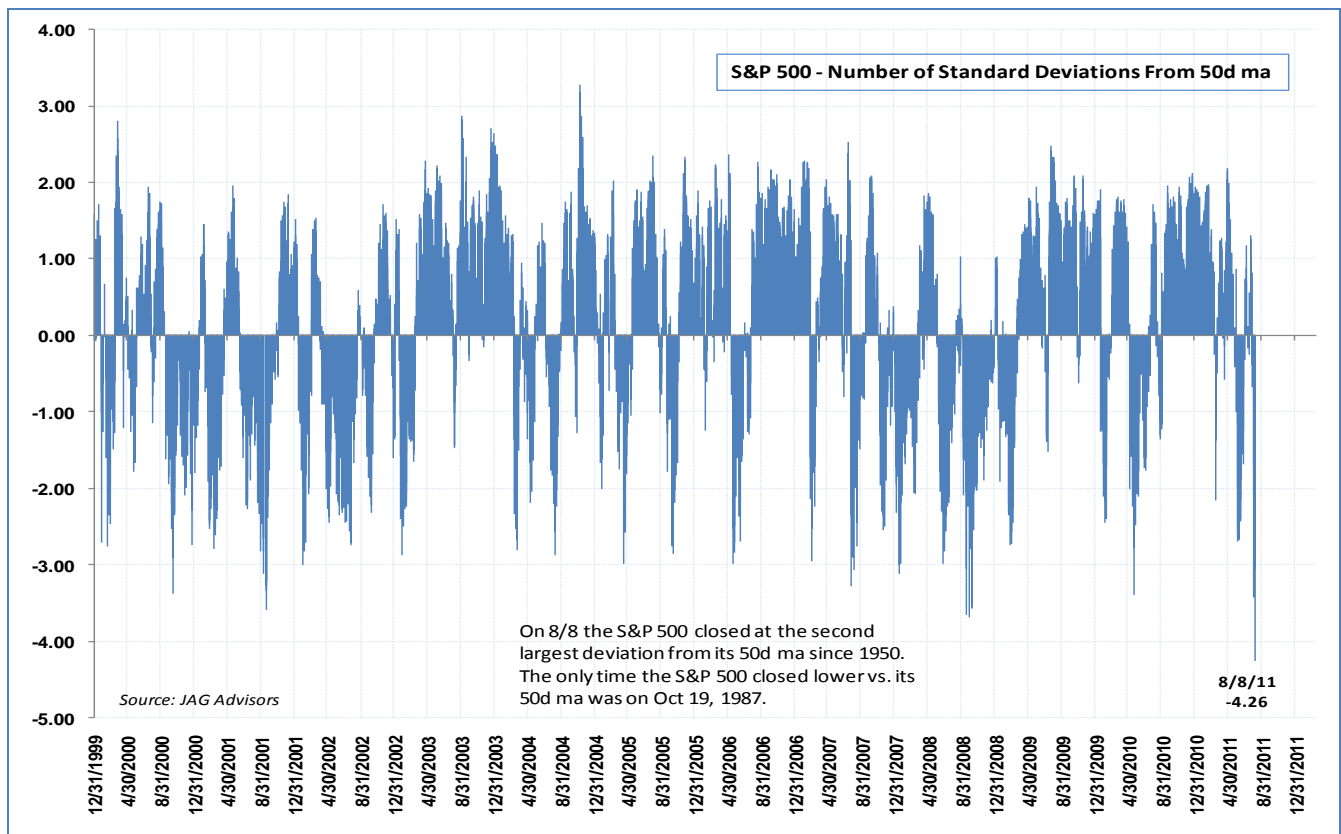
### Equity Market Update

The S&P 500 has corrected by 16.8% in the 11 day period ending August 8. In our opinion, the initial correction began due to a variety of reasons, including angst over some softer-than-expected economic reports in July, the “theater of the absurd” debates in Congress over the debt ceiling, and the growing sovereign debt crisis in Europe.

Following S&P’s downgrade of the U.S. credit rating last Friday, a brisk flight from all risk assets has continued to punish equities this week:



The speed and severity of this stock market decline has been extraordinary to say the least, but the S&P 500 is now in deeply oversold territory. The chart below shows that the S&P 500 closed at a level 4.26 standard deviations *below* its 50-day moving average. Since 1950, the market has only been *this* oversold once...namely, during the Crash of 1987.



Additional historical analysis recently by the excellent researchers at Bespoke Investment Group (“S&P 500 Fifth Most Oversold Close Ever,” 8/8/11) provides further context. Bespoke notes that there have only been ten other days since 1928 in which the index closed more than four standard deviations below its 50-day moving average. Importantly, they further note that in all ten of those previous instances, the S&P 500 was trading higher six months later – producing an average gain in excess of 8%.

### **JAG’s “Game Plan” for Equity Portfolios**

In times like this it is important to remember what stocks actually are. Obviously they represent shares of ownership in corporations. But stocks are also: (a) discounting mechanisms for long streams of future income; (b) generally more liquid than many other financial assets; and (c) susceptible to dramatic price swings from time to time. While these three attributes combine to make stocks extremely attractive *long-term* investment vehicles, they can also make stocks incredibly painful to own for shorter-term periods.

Equities are clearly experiencing outside market volatility during this correction. What is more, this is volatility of the “bad” kind – in other words, prices are declining rapidly (note: in our experience, most investors can handle *unlimited* upside volatility). Jim Cramer, the popular former hedge-fund manager and CNBC commentator, has remarked that this recent bout of seemingly “machine-driven” selling reminds him of the ‘87 Crash more than the financial crisis of 2008. We agree with his analogy, and we would add that the current market also is reminiscent of the 1997 “Asian Contagion” currency crisis and the sharp sell-off that resulted from the failure of a large hedge fund (Long-Term Capital) in 1998. Each of those corrections was relatively short, sharp, and scary, but each was ultimately followed by a recovery in the stock market the subsequent several months.

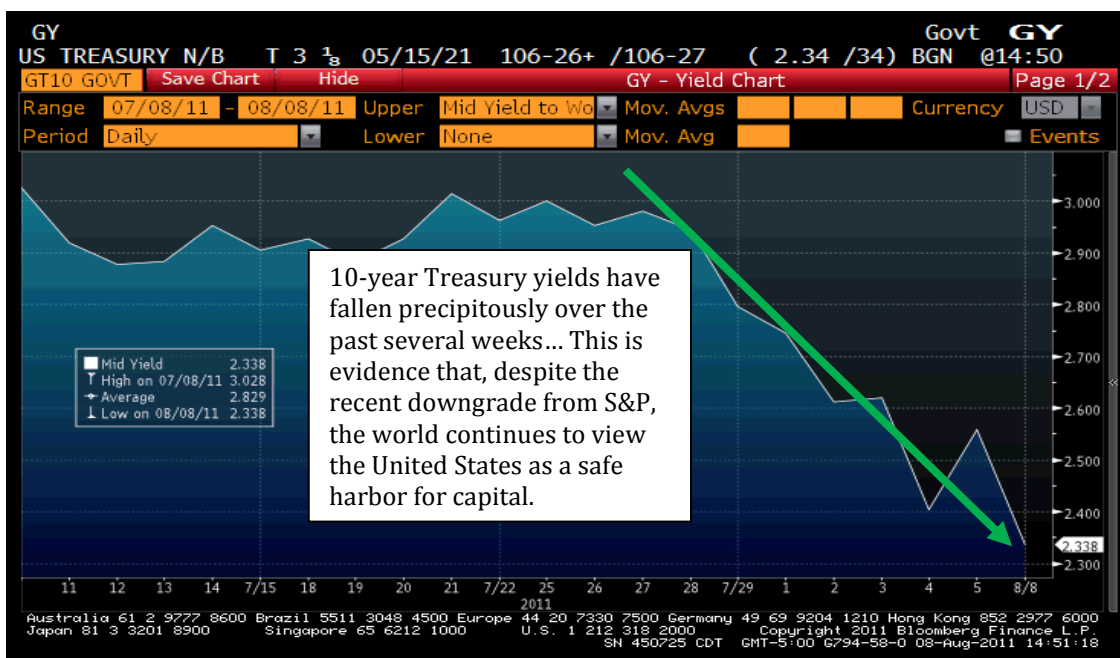
This time around, the market seems to have quickly priced in a high probability (probably on the order of 50/50) of another global recession later this year. Should such a recession actually occur, stock prices might have further to fall. On the other hand, if the economy is able to *avoid* slipping into recession, we could see meaningful upside for stocks between now and early 2012.

We have helped our clients navigate a number of market crises over the past decade, including each of the events mentioned earlier, as well as more recent events such as the bursting of the technology bubble in 2000, the aftermath of 9/11, and the financial crisis of 2008. Throughout each of these periods, we have relied upon the following principles to guide us:

- Significant portfolio adjustments should be made as unemotionally as possible. Over thousands of generations, our mental toolbox has evolved to give us many wonderful tools to deal with life's challenges. Unfortunately, since modern financial markets have only developed over the past couple of centuries, much of our built-in "wiring" is ill-equipped to deal with the complex skills necessary for successful investing. Although our "flight or fight" instinct did a great job helping our ancestors escape saber-toothed tigers in eons past, it is much less helpful in helping us decide what to do with our stock portfolios. Therefore, it is absolutely vital that investors exclude emotion when considering whether to buy, sell, or hold an asset. Since sharp market declines are, by definition, at least partially driven by emotion, it has generally not made good sense to make large investment decisions during such declines.
- Selling crescendos are not optimal environments for selling. As we detailed in one of the charts above, this stock market sell-off has truly been one for the history books. There is an old saying that goes, "To a baby with a hammer, everything looks like a nail." Likewise, during any severe market sell-off, just about every stock "looks" like a "sell." But if we step back from the situation and look at it objectively and with the benefit of long experience, we know that this is wrongheaded. During periods of market stress, competent investors should seek to *avoid* indiscriminate selling, in favor of waiting for calmer moments in which to arrive at rational decisions.
- Crisis create opportunities. Every single market crisis that we have seen has created interesting and profitable investment opportunities, and we have no doubt that this one will be any different. In fact, given relatively low valuations in the stock market (compared to the valuations with prevailed prior to 2000-2002 and 2007-2008 periods, for example), we think it is probable that the aftermath of this particular correction will bear more fruit than previous market disruptions. As always, time will tell. But in the meantime, we will do our best to find the best investments we can in the coming months.

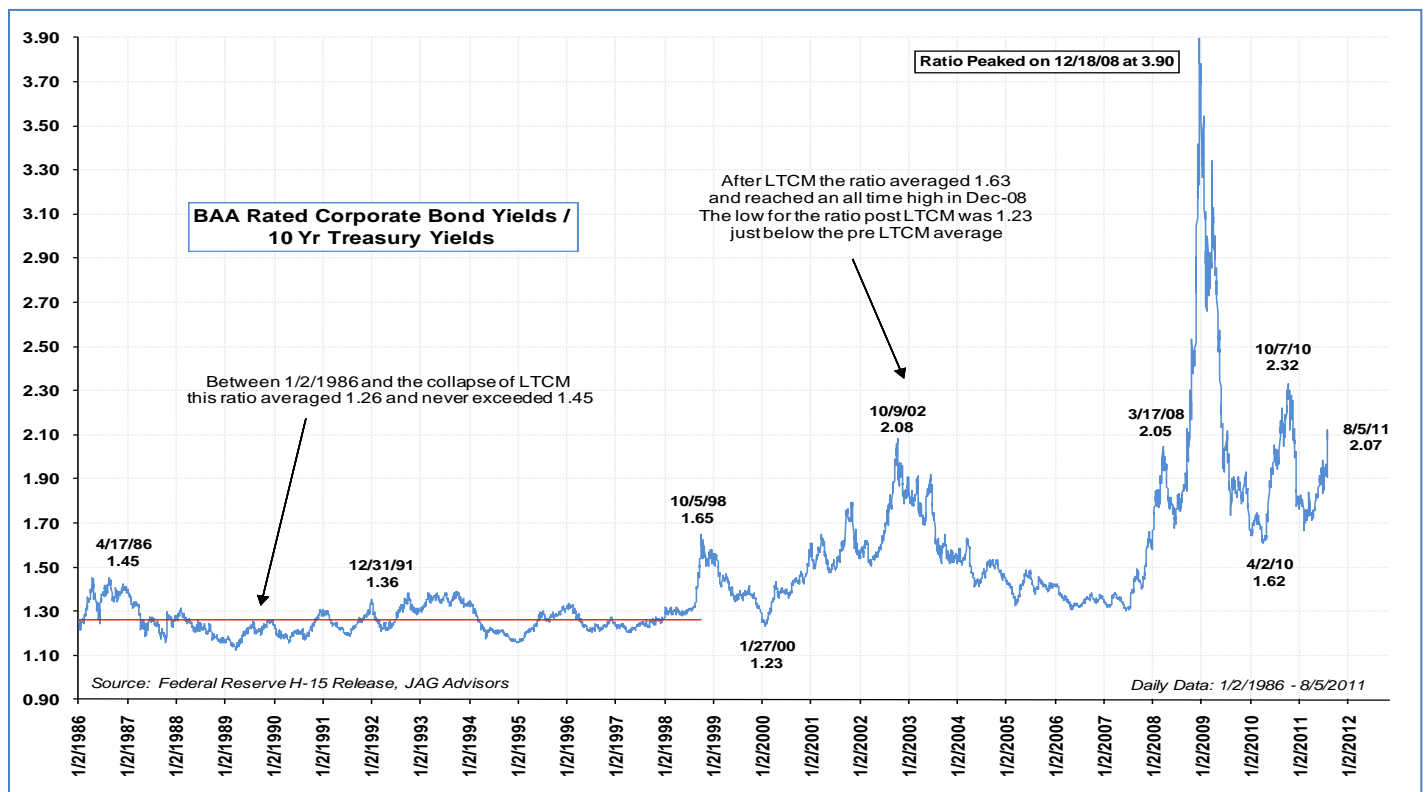
### **Bond Market Update**

Ratings agency opinions aside, we believe that investors still believe that the "full faith and credit of the United States" is as iron-clad a guarantee as is available anywhere in the world. The recent movement in 10-year Treasury yields supports this assertion. Yields have fallen dramatically over the past 30 days as demand for U.S. Treasury obligations remains extremely robust:



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Given the global appetite for yield, as well as the robust financial health of U.S. corporations, we do not expect corporate-to-Treasury yield spreads to “gap out” to the extreme levels we saw in late 2008. While it is possible that corporate bond yield spreads could expand somewhat – especially in the event of a “double-dip” recession scenario - we expect that any such expansion would remain contained:



### **JAG's "Game Plan" for Bond Portfolios**

Many of the larger fixed income asset managers invest a significant percentage of their clients' portfolios into Treasury and Agency securities. Since those securities have always been carried at a rating of AAA, these managers have historically had the flexibility to invest in lower-rated corporate bonds with the remainder of their portfolios. However, S&P's rating downgrade may compel some of these professional portfolio managers to *rebalance* their portfolio compositions to ensure they maintain the required average credit rating in their portfolios. In practice, this process would require them to *sell* some of their corporate bond holdings, which would then allow them to *buy more* Treasury and Agency securities.

If this were to occur, we would expect to see wider yield spreads unfold in certain segments of the corporate bond universe, including BBB-rated and below investment-grade bonds. As value-centric fixed income managers, we at JAG would view such a development as a buying opportunity. We will always seek to maximize the risk-adjusted potential return of our fixed income portfolios.

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