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# Update

Unless otherwise noted, all figures are based in \$USD

## Market Forces

### Complex Problems, Patchwork Solutions

As if the first quarter of each year weren't stark enough given the wintry weather, a chronic lack of daylight, and the annoying realization that it is once again time to start preparing one's income taxes, troubling performance in the equity markets generated a bit more despair. The Dow Jones Industrial Index and the S&P 500 Index both dropped by about 10%; the NASDAQ got hit even harder, falling more than 15%. And outside the continued strong performance of U.S. Treasuries, returns in the other credit markets were hardly inspiring.

The financial markets were already struggling when the first quarter of 2008 began given the credit crisis that erupted last year due to many subprime missteps. Things deteriorated during the quarter when it became apparent that the overall economy was now struggling, and the situation was exacerbated by a concurrent spike in commodity prices. The problems seemed to culminate in mid-March when the Federal Reserve had little choice but to step in and broker the fire sale of a major Wall Street firm, Bear Stearns, to JP Morgan Chase. In an effort to avert additional liquidity crises, the Fed also opened up the discount window to all Federal Open Market Committee (FOMC) primary dealers, something it has not done since the 1930s.

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## Investment Approach

### Emotion in the Driver's Seat

The headline in the Wall Street Journal on March 12, 2008 read, in part, "Dow Rallies 416.66 Points, Best Day in Five Years".

Many would find it hard to believe that this is a headline from just a few weeks ago. After all, the domestic equity markets have lost 10%-15% so far in the first quarter of 2008. For the most part, the news is bad all over; many feel that the U.S. is already in recession, and oil prices have surged well over \$100 per barrel. And if that isn't enough, we are witnessing what we can only hope is the biggest fallout from the current credit crisis – a fire sale of an 85-year-old investment bank in an attempt to fend off bankruptcy.

So how could the markets manage an impressive one day return during a quarter that witnessed such bad news? This kind of extreme swing between negativity and euphoria can only happen in an environment where emotion is in the driver's seat.

Emotion tends to be a driving factor in response to a *surprise* outcome or event. In contrast, when there is some level of *expectation* about a potential outcome or event, we are better equipped to use rational judgment or discipline in our response.

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## Investment Approach

As 2007 came to a close and we entered 2008, the surprise event for the markets, and for Manning & Napier, was the extent of subprime woes.

Here's what we were prepared for: first, we recognized that the U.S. housing market had reached bubble territory and would burst, inevitably rolling over into a bear market; we were aware that the bursting of this bubble would uncover questionable lending practices that would ultimately cause some degree of foreclosures. Secondly, we recognized that these conditions would weigh heavily on the U.S. consumer and, in conjunction with higher gas prices and higher debt service, would slow spending going forward. Of course, we discussed how all of these factors would lead to slower growth in the U.S. and, eventually, the global economy.

Consistent with our overview, we were not invested in housing-related companies going into 2007. While we were invested in a variety of financial services companies, we focused on institutions with diversified product lines rather than traditional retail lenders. In addition, we avoided big ticket consumer stocks. Generally speaking, our equity holdings were in companies with specific, non-cyclical growth drivers, and our fixed income holdings were focused on high-quality securities such as U.S. Treasuries. For the first three quarters of the year, this positioning paid off.

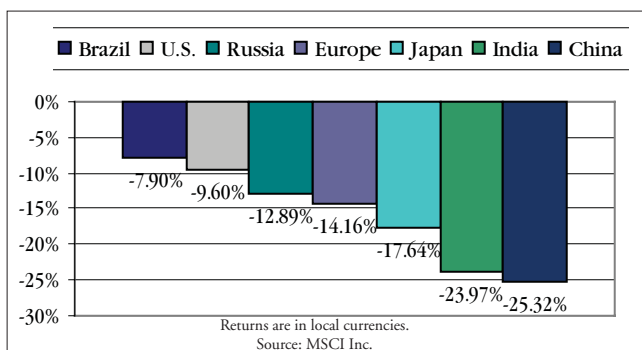
But there was more to unravel.

Like the majority of investors and investment professionals, we did not foresee the full extent of the problems related to questionable loans made during the bull market in U.S. housing. Beyond widespread foreclosures, the securitization of mortgage loans spread bad debt throughout the banking and financial system, even beyond U.S. borders. A significant credit crunch resulted, with the severity of the situation now best illustrated by the fall of Bear Stearns.

This financial crisis has affected not only financial services companies and consumer discretionary stocks, but has led to a broad-based global downturn in stock prices. The reality is that no area of the market has been safe. And it's not just the U.S. markets feeling pain.

### MARKET RETURNS AS OF 3/27/08

While the focus is on U.S. based economic issues, market volatility is widespread.



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The events of the past few months have left investors disappointed and we at Manning & Napier find ourselves feeling the same way. We are never satisfied when we are not delivering strong returns for our clients. That said, the very nature of a surprise is that it cannot be controlled. For that reason, we find ourselves looking to what we can control right now, and that is our commitment to discipline.

While we were unfortunately as surprised as most of the markets at this extreme turn of events, we've not lost sight of our responsibility to our clients, which is to resist the emotional, knee-jerk reaction to run, and instead to remain rational and disciplined.

Rationally speaking, we have to examine the environment surrounding this downturn in stock prices. It appears to be largely a fear-based decline. Clearly, consumers are no longer in a position to drive economic growth and the current credit crisis limits the ability of businesses to contribute meaningfully. Economic growth will slow and it has become more likely that a recession will occur. That said, from a bottom-up perspective we can't ignore the fact that many U.S. companies were trading at attractive or fair valuations *before* the recent downturn shaved another 15% off prices. This is not a correction prompted by speculative valuation levels that became disconnected from underlying fundamentals. Rather, this downturn is driven by liquidity concerns and the fear of recession – factors which may or may not affect the fundamentals of individual companies.

Given this rationale, we must remain disciplined in our investment approach. To run to the sidelines today would not only result in selling stocks at depressed prices, but would also represent an opportunity cost. Simply put, it would be reckless of us to get rid of good companies whose fundamentals should remain intact through the current turmoil, but whose prices have fallen for no reason other than fear.

Our discipline has led us to view this price decline as an opportunity to upgrade the portfolio by adding to or initiating positions in companies with solid fundamentals that can hold up during an economic downturn. In addition, we've taken the opportunity to invest in the strongest companies in industries facing extremely negative sentiment.

We've been quite active in client portfolios over the past six months, repositioning holdings to take the most advantage of this widespread downturn. In fact, the last time we initiated a major repositioning of client portfolios was during 2002 – the worst year of the last bear market. At that time, similar to today, we bought into declining prices to position client portfolios in companies with solid fundamentals and depressed prices. This strategy served our clients well in the bull market that followed.

Looking forward, we expect continued slow U.S. growth over the near-term as the consumer faces a tougher

employment environment and tight lending standards. Moreover, leading indicators in developed nations indicate that the slowdown has global reach. Given the role of developed nation consumers as buyers of developing nation goods, we fully expect the slowdown to put the brakes on emerging market growth as well. This is likely to moderate inflation concerns over the near-term. We won't be surprised to see today's credit crisis have long-reaching implications, restricting liquidity well into the future.

It's unclear how long investor emotion will be in the driver's seat of this roller coaster ride, though sentiment is currently at levels similar to major market bottoms. The ride will be uncomfortable while it lasts, but we believe our clients have an advantage in terms of staying on track. That advantage is our commitment to making decisions based on discipline, not emotion – an approach that has allowed us to make the most of volatile markets over the last 35 years. 📈

## Market Forces

*Continued from page 1*

Given the credit crisis, investors continued to reign in their risk tolerances. The result was even wider credit spreads in the investment grade, as well as below investment grade, areas. U.S. T-bill yields fell to 50-year lows and the auction rate securities market collapsed, contributing to the implosion of numerous hedge funds. The credit crisis continued to hammer the major Wall Street brokerage firms – Goldman Sachs, Merrill Lynch, Morgan Stanley, and Lehman Brothers all posted significantly lower earnings along with 10-digit write-downs.

As for the economy, the problems that began in the housing sector not only wreaked havoc within that sector (i.e. lower sales, falling prices, rising foreclosures), but they also appeared to spill over into other sectors of the economy. Consumer confidence deteriorated with payroll growth turning negative and jobs becoming increasingly hard to find. That spilled over into the spending numbers, with retail sales figures down sharply in February. In the manufacturing sector, the Institute of Supply Management Composite Index dropped below 50, the “break point” between expansion or contraction within that sector; durable goods orders were quite disappointing, and the Philadelphia Fed Index of Business Activity went negative for the first time since the last recession.

Typically when economic activity is slowing, commodity prices fall. The exact opposite occurred during the first quarter of 2008; oil prices zoomed through the \$100 a barrel level hitting all time highs, gold prices briefly touched \$1,000 an ounce, and the CRB Commodity Index, which is dominated by grain prices, was up by as much as 20% at one point during the quarter. While foreign demand, especially within emerging markets, may have been the major factor behind those

increases, they nonetheless stoked inflation fears, which is understandable given the fact that both the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) deflator were now growing at year-over-year rates of about 4%.

The Federal Reserve monitored these developments throughout the quarter, and continued to push the Fed Funds target lower. The Fed first cut short rates in September of last year. That 0.50% rate cut was followed by a 0.25% cut in October, and another 0.25% cut in December. A massive trading loss at a European bank and marked sell-offs in the equity markets triggered an inter-meeting rate cut of 0.75% in mid-January of this year. That was followed a week later by an additional 0.50% cut at the regularly scheduled January 2008 FOMC meeting. At the last FOMC meeting in March, the Fed Funds target was cut yet again, this time by another 0.75%, bringing it down to 2.25%.

However, cutting rates was not the only thing the Fed did during the first quarter. In January, in an effort to help calm/stabilize the financial markets, the Fed extended its new bank liquidity mechanism, Term Auction Facilities (TAF). That facility had just been introduced a month earlier. In March, it created the Primary Dealer Credit Facility (PDCF) that allows primary dealers to swap mortgage paper for U.S. Treasury securities, which are far easier to finance. And then, less than a week later, it opened up the discount window to all primary dealers, allowing them access to overnight funds for a variety of different investment grade collateral.

It should be noted that these actions were designed to provide the financial markets with liquidity so they could continue to work through the credit problems that have accumulated over the past few years. These responses were in no way meant to solve those problems. That is a process that will have to be worked through over the next few quarters. A weakening economy, concerns about commodity prices, and the ongoing credit clean-up, obviously weighed on the markets, and that was clearly reflected in their performance.

However, there is always reason for optimism. For example, as dismal as the winter months can be, the silver lining is that spring will eventually arrive; the chill will leave the air, the days will get longer, and the April 15th tax date will come and go. Similarly so with the markets; it has been a tough stretch, but with the Fed cutting short-term interest rates and providing financial markets with necessary liquidity, along with, most importantly, the financial community addressing its credit problems, the investment environment will ultimately improve. In the interim, there are numerous company-specific opportunities from which investors can benefit and uncovering those opportunities is where Manning & Napier has been focusing its energy. As the saying goes, “all good things come to he who waits”. 📈

## Consider This

### How to Prevent Fear & Greed from Derailing Your Investment Goals

There is an old cliché about “fear and greed driving the financial markets” that dates back to John Maynard Keynes in the 1930s, but still rings true today. In times where fear and greed intersect, financial markets often experience meaningful volatility. Unfortunately, fear and greed are usually most pronounced during market extremes when investors are prone to letting emotions dictate their investment decisions.

All too often, when investors, including professional investors, let emotions drive their thinking, they end up making poor decisions that can derail long-term investment plans and goals. Another unfortunate reality of the fear/greed cycle is that many financial companies launch “new and innovative” products designed to feed the prevailing emotion, whether it be greed or fear. When considering these new products, investors would be wise to keep in mind an even older adage: “if it sounds too good to be true, it probably is”.

Leading up to the last five months of increased market volatility, greed was driving some investors’ behavior. Many lost sight of, or chose to ignore, the potential risks associated with investment products and strategies that offered the allure of above average returns. This group included speculators in real estate, fixed income investors chasing incremental yields in auction rate securities, and financial institutions that failed to document and verify income levels for mortgage applicants.

The greed demonstrated by some investors eventually led to the current environment, where the prevailing emotion is fear. Not surprisingly, financial companies have responded with new or re-packaged products designed to play on investors’ fears. As an example, one insurance-based product offers upside equity market participation while guaranteeing investment principal. That sounds good, in fact, probably too good to be true.

An evaluation of the fine print reveals that the product has several limitations such as capped returns and a required 10-year holding period. The result of all of the limitations is that the product’s average annualized return since 1926 would have been far more bond-like than equity-like. However, the product’s principal guarantee

was clearly designed to appeal to equity investors fearful of the recent volatility increase in the equity markets.

Beyond resisting investment products that sound too good to be true, investors should also keep in mind these simple guidelines to prevent fear or greed from derailing their long-term investment goals:

- **Understand and diversify risk to the extent possible.** Investments should be selected with both risks and goals in mind.
- **Beware of projecting forward historical averages or recent market trends.** Investors should realize that the stock market is inherently volatile and that market conditions will change in the future.
- **Understand the limitations of performance statistics. Examine results over a full market cycle to understand better the potential risk of a strategy.** Additionally, make sure that the results being evaluated represent actual performance experienced and not hypothetical returns unlikely to be earned by actual clients.
- **Understand relevant fees and make sure the advisor’s interests are aligned with yours.** Investors should closely monitor all fees and expenses associated with their investments and ensure that their advisor’s incentives result in objective advice and guidance.

In order to prevent the fear/greed cycle that permeates the financial markets from derailing long-term objectives, investors need to develop a disciplined and well-designed plan for attaining their goals, and they need to stick to the plan when emotions are driving the markets. In addition, regardless of any financial company’s promise to the contrary, investors should remember that strong returns without incremental risks are just too good to be true. ♡

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**Reminder:** Please submit a new withdrawal authorization form or a corporate resolution if there is a change to an authorized party listed on your account(s).

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