

WEDGEWATCH

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The Times They Are A-Changin'

"There is nothing wrong with change, if it is in the right direction."

– Winston Churchill

The rising decibel level of the drumbeat for *change* is not just confined to the political arena these days. If you've owned stocks over the past year, especially those in the financial sector, change is likely a paramount focus for you as well. However, absent a blatantly obvious shift in trend, a mere glimmer of clarity regarding credit losses might be sufficient to calm the nerves of investors (at least for a while). Unfortunately, such clarity remains elusive despite some very heavy lifting by the Fed. As a result, the ongoing inability of investors to confidently gauge or handicap the magnitude of the subprime and structured finance debacle continues to weigh on the broad market, in general, and the financial stocks in particular. Not surprisingly, given that backdrop, investors remain myopically focused on the next relevant credit-related data point for tangible signs of containment and/or stabilization. Writing on this topic in his insightful and often humorous newsletter, *Grant's Interest Rate Observer*, Jim Grant, a hardwired and long-tenured financial skeptic, provided his own somewhat tongue-in-cheek assessment of the immensity of the calamity: "Yes, it's contained. It's contained to the planet Earth." A clever and sober assessment for sure, but one not likely of great amusement if ultimately proven true. On a related note, in politics, just as on Wall Street, our nation's state of affairs, good or bad, is often "self-inflicted." A misspoken line from a speech on the war against terrorism, delivered by a prominent U.S. political figure, could pretty well sum up the collective foibles, intended and otherwise, of our elected officials in Congress: "Our enemies are innovative and resourceful, and so are we. They never stop thinking about new ways to harm our country and our people, **and neither do we.**"

Sadly, Wall Street, Congress and, most importantly, the American people share a common nemesis – growing deficits of unknown proportions. However, in time, **change will eventually come.** It always does, especially in Washington and on the trading floor of the NYSE. That said, if you're a believer in the Wall Street adage – *the trend is your friend* – then 2008 appears to be starting off as a *change-related bonanza* full of "firsts." Consider the following:

- 1) Terriers have long dominated the annual Westminster Kennel Club Dog Show in New York City. However, this year, in a welcome change, a very handsome and happy little beagle named Uno won *Best in Show* for the first time in the 132-year history of the illustrious event (finally Snoopy gets his due).
- 2) In Washington, D.C., the prototypical resident of the Oval Office has remained status quo, more or less, since George Washington was elected our nation's first Commander-In-Chief. This year, however, for the first time, there appears to be a real possibility that voters might elect either a woman or an African American to lead our great country into this millennium's second decade. If either scenario plays out, it will represent *monumental change*. For that matter, even if Senator John McCain secures the White House, that too would represent notable change, as he would be, by three years, the oldest first-term candidate ever elected to the nation's highest office (he turns 72 in August).

First Quarter 2008 Financial Statistics

DJIA: 12262.89

S&P 500: 1322.70

90-Day T-Bill: 1.32%

30-Yr. T-Bond: 4.29%

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A-Changin'

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- 3) For decades, the Federal Reserve Board has routinely advocated an incremental approach to changes in monetary policy (though Alan Greenspan's easy money binge, post the popping of the dot.com bubble in March of 2000, was certainly a marked departure from that philosophical bias). Earlier this year, however, Federal Reserve Chairman Ben Bernanke, better known as "Helicopter Ben" to some, abandoned any bias toward incrementalism by aggressively lowering the fed funds rate a rather astonishing 125 basis points in only four days. The timing and magnitude of that abrupt change was also a first (from such a low starting level of absolute interest rates).
- 4) The dollar, which has been in an increasingly well-publicized multi-year bleed, recently made new record lows against the Euro. A most dubious and embarrassing first.
- 5) Oil prices, historically a major headwind for the economy when abnormally high, powered through \$100 a barrel for the first time last month (a new absolute high). An inflation-adjusted record price was also recently set, surpassing the crippling inflationary peak of the early 1980s.

"I always thought that record would stand until it was broken."

– Yogi Berra (1925 to present), Hall of Fame catcher for the New York Yankees

It's been said that there is **a first time for everything** (and so it seems). Clearly though, some precedents are far less welcome or pleasing than others. For example, Bill Gross, *Pimco's* oft-quoted fixed income seer, recently opined on one such "first" stating: *"We've never faced this, in reality, in terms of our modern financial system."* He was referring to the credit-stress that continues to seize up the nation's lenders and capital markets and the Fed's seeming inability to do anything about it (despite a very aggressive cumulative 300 basis point easing response since last September). *"Those looking for quick overnight miracles are going to be disappointed,"* Gross warned. Richard Bernstein, Chief Investment Strategist at *Merrill Lynch*, voiced his own surprise and dismay at the Fed's seemingly futile efforts to enhance market liquidity and drive down credit spreads and mortgage rates. *"We confess that we have been in the business for 25 years and have never seen a*

cycle like this one." Not particularly warm fuzzy thoughts from two well respected and seasoned Wall Street veterans.

"I think Bernanke is in a very difficult situation. Too many bubbles have been going on for too long. The Fed is not really in control of the situation."

– Paul Volcker, former Fed Chairman, commenting in the January 20th issue of the *New York Times*

Such pessimism, or realism, depending on your perspective, begs the question: *how do such remarkably shaky credit underpinnings affect the outlook for stock prices from here?* Given the relatively consistent history of Fed-induced equity market recoveries (especially since the early 1980's when Paul Volcker bluntly broke the back of a severe inflationary spiral), the tepid equity market response to aggressive monetary ease, so far this cycle, is almost certainly disappointing to the rapidly dwindling fraternity of Wall Street bulls. As things stand at quarter's end, since the Fed began to ease on September 18th of last year, investors are far from ebullient, as the S&P 500 is down 15.5% from its October 9, 2007 peak, and credit spreads have widened *significantly* across the board. *Apparently, at least for now, the Fed's medicine has failed to kick in.*

With all that said, and with no appreciable signs of improving sentiment on the horizon, a contrarian view might suggest **the market could be building toward a classic capitulation bottom**, if it hasn't reached one already. However, if the current decline turns into a full-blown bear market, and it certainly teetered on the brink recently, history points to more pain ahead for holders of stocks, down at least another 15 to 20%, before the broad market can make a definitive low for the cycle. We'll elaborate on this in a moment.

A review of stock market history shows that **equity market bottoms are often triggered by economic downturns**. Given recent economic data, it remains only mildly debatable now whether or not the U.S. economy has officially entered recession. At a minimum, it certainly seems implausible to dispute that we are in the midst of the most severe credit downturn since 1990, especially given the very weak and still increasingly volatile backdrop for credit, housing and jobs (e.g., the shocking and stunningly swift collapse of

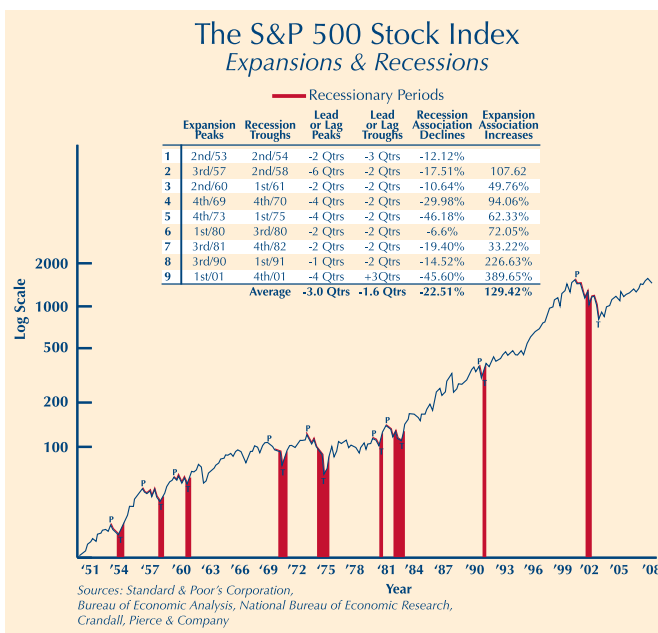
Bear Stearns last month). It's also worth a reminder that history shows *credit cycles* are typically associated with economic contractions and/or recessions. With that in mind, and cognizant of the anecdotal “winds of change” highlighted earlier, *let's review what financial market history tells us about stock market corrections and bear markets. In addition, let's study the history of equity market returns following sell-offs of relatively sizable magnitude, especially those associated with a subsequent recession.*

Since 1945, the average decline for S&P 500 corrections (typically defined as down 10 to 15%) has been 12.2%, with the peak-to-trough decline averaging just 3.5 months. For declines between 15 and 20%, like the one we're in the midst of, the average sell-off was 17.9% (average duration – 4.3 months). If the recent equity market downturn (at its low on March 10th, down 18.6% from the early October peak) can ultimately sidestep the bear market threshold of down 20% or more, history suggests incremental downside risk should be rather modest. It is worth noting, however, that since 1900 according to *Ned Davis Research*, using the *Dow Jones Industrial Average* as a proxy, once the index is down 15% there is a better than even chance (54%) the total damage will be 20% or more (as negative investor psychology is prone to feed on itself to an extreme).

Attention-grabbing corrections of 10 to 15%, though relatively infrequent, have occurred on average once every 1.5 years, since 1945, while more extreme “confidence-rattling” declines of 15 to 20%, have been far less frequent, at once every 3.7 years. *Given the S&P 500's substantial and sustained rally off the post-dot.com bust low of October 9, 2002 (+108% on a total return basis or 15.0% CAGR through year-end 2007), it should not come as a major surprise that stocks have been struggling recently.* This is especially true given the weak and still evolving economic and credit market backdrop which, according to no less an authority than Warren Buffett, recently pushed our economy into recession. Going forward, avoidance of the dreaded bear market would seem the most immediate hope of investors; **especially since the average bear market decline since the end of WWII has been a very ugly 32.8%, with the average duration far more extended at 1.5 years, peak-to-trough.** Of primary note, as of March 31st, it had been nearly six months since the S&P 500 reached its cycle peak. During that time, per the low set on March 10th, *the index had sold off a little more than half the typical bear market decline just cited.*

Let's turn to **recession-driven equity market downturns** next. Since 1950, according to the *National Bureau of Economic Research*, *there have been nine official recessions. Measured from the peak of the economic expansion to the trough of the subsequent recession during each of those incidences, the average price decline in the S&P 500 has been 22.5%.* The worst decline, down 46.2%, started in 1973 and lasted a little over a year. This was followed closely in magnitude by the bursting of the dot.com bubble in early March 2000, which produced a peak-to-trough decline of 45.6%. Importantly, both those market upheavals, along with the 1969 market reversal (down 30%), were preceded by valuations markedly above the long-term average (price/earnings multiples ranged between 18.0x and 29.0x). Excluding those three mind-numbing market swoons, all the other recession-related equity market declines were much more benign (see **Chart 1**). Given today's far from expensive valuation backdrop for the S&P 500 (13.5x forward year estimates), especially relative to the ultra-depressed yields in the Treasury market, we see reason for longer term optimism from a risk/reward perspective (though “fat tail” risk certainly remains).

Chart 1



Now let's address the kicker (the proverbial “silver lining”), **how big is the party after the lows are in for the cycle?** According to *Ned Davis Research*, since 1949 the average six-month price gain for the S&P 500 off a recession market lows has been 24.1%, while the average one-year gain, off those same recession-related lows, was 32.4%. Looking out across more extended time horizons, cumulative stock returns (on a price basis) over the subsequent periods of

economic expansion and recovery (from economic trough to peak) have been remarkably robust, averaging 129.4% over the eight periods measured (again see **Chart 1**).

Moving beyond only recession-related stock market downturns, since the depression-triggered bear market of 1929-32 (by far, the worst on record; contracting 86.2% peak-to-trough), **the average percentage one-year gain off the thirteen bear market bottoms, including the 1932 trough, has been a very robust 52.3%** (see **Chart 2**). Importantly, and as a further cautionary note to those feeling the very seductive pull toward cash as the heat in the market ratchets up, compound annual total returns for the S&P 500 over the ten years ending 12-31-07, were nearly *500 basis points lower if one simply excludes the six best performing months for the index during that period* (5.9% vs. 1.1%). The message for would-be market timers: *caveat venditor* (seller beware).

Chart 2

S&P Performance After Bear Markets

Bear Markets*	% Drop	Months	P/E at Trough	% Rise In Next Year
09/07/29 to 06/01/32	-86.2	33	26.3	121.4
09/07/32 to 02/27/33	-40.6	6	30.0	95.5
02/06/34 to 03/14/35	-31.8	13	24.8	81.4
03/06/37 to 03/31/38	-54.5	13	14.3	29.2
11/09/38 to 04/28/42	-45.8	42	11.1	53.7
05/29/46 to 06/13/49	-29.6	36	7.8	42.1
08/02/56 to 10/22/57	-21.6	15	16.2	31.0
12/12/61 to 06/26/62	-28.0	6	19.0	32.7
02/09/66 to 10/07/66	-22.2	8	17.9	32.9
11/29/68 to 05/26/70	-36.1	18	18.4	43.7
01/11/73 to 10/03/74	-48.2	21	10.2	38.0
11/28/80 to 08/12/82	-27.1	20	12.1	58.3
03/24/00 to 10/09/02	-49.1	31	26.6	19.9
Average				52.3

*Stock market declines lasting at least six months with a percentage price drop of at least 20%.
Source: The Bank Credit Analyst

methodically allocate more dollars to equities amidst the increasingly pervasive uncertainty that has unfolded. In that regard, the old saying *pay attention to what they do, not what they say* seems highly apropos today. Case in point, although he has recently reemphasized his long-held belief that investor expectations for future stock returns remain too high, *Berkshire Hathaway's* Warren Buffett, the prototypical long-term investor, has allocated \$36 billion to equities (on a gross basis) over the past three years, with a major step-up in commitment in 2007 (\$19 billion). By comparison, his gross purchases for the combined two years prior to 2005, totaled only \$3.9 billion. After an extremely patient wait, it appears that Mr. Buffett is now finding a relative abundance of choice morsels to satisfy his pent-up appetite for mispriced stocks.

The recently deceased journalist and bon vivant William F. Buckley Jr., born just a few years before the onslaught of the Great Depression, was a uniquely keen and insightful student of the human race. As a result, he

As highlighted earlier, there's a first time for most everything, so we must acknowledge that anything is possible, both good and bad, going forward. However, the anecdotal backdrop just articulated suggests that long-term investors should stay the course, if not

spoke with some authority on the resiliency of the American spirit. In a 2006 address at Yale, his alma mater, he summed it up this way, *"Despair is inappropriate for a culture as buoyant as our own."* An

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accurate assessment for sure. However, despite the long-evident core optimism of the American people, there are *no guarantees* that the optimists aren't missing something diabolically structural in the economy and/or the financial markets that ultimately makes this cycle ominously different for equities; overwhelming the "die-hard" bulls that see "a glass half-full," not half-empty.

With that said and with our eyes wide open, we fully acknowledge the risk, discomfort and uncertainty of the *monumental* credit unwind playing out before us. However, such systemic cleansing was long overdue, a necessary evil that had to eventually be acknowledged, willingly or not. When the dust finally settles, the ultimate by-product of what was an unrestrained credit orgy of epic proportion may very well be the emergence of profound change to the capital and credit markets. Put simply, *the era of unregulated, unsupervised credit market disintermediation* (ushered in by the de facto

repeal of Glass-Steagall in 1994) *could be over*, not to be seen again, at least in such reckless and profligate form, for years to come. In the meantime, **long-term opportunity appears to be emerging for the discriminating buyer of stocks.**

We'll close with a bit of nostalgia. Though investment and economic cycles were surely far from his mind at the time, the following lyrics, from one of legendary songwriter Bob Dylan's most famous songs (circa 1964), could easily have been written to provide important insight and perspective on the rapidly evolving investment landscape of the present day. A timeless message meriting serious investor heed:

*The line it is drawn, the curse it is cast
The slow one now, will later be fast
As the present now, will later be past
The order is rapidly fadin'
And the first one now, will later be last
For **the times they are a-changin'.***

Index	03/31/08 Price	1st Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	12262.89	-7.6%	-7.6%
S&P 500	1322.70	-9.9	-9.9
Value Line Composite	390.44	-11.3	-11.3
American Exchange Comp.	2231.83	-7.4	-7.4
NASDAQ Composite	2279.10	-14.1	-14.1

*Does not include dividend income.

Fixed Income

Opportunity Knocks

As the current credit cycle rolls onward, virtually every spread sector has been dramatically re-priced to reflect increased perceptions of risk. Indeed, from high quality corporate bonds to newer areas of the "structured finance" sector, spreads have widened dramatically during the last six months. Liquidity, which only a short time ago seemed to be in such abundant supply, has all

but evaporated in certain pockets of the fixed income markets. Despite massive action by the Treasury and the Federal Reserve, "fear" has dominated "greed." When this happens, a "run on the bank" scenario can develop quickly, as the recent *Bear Stearns* debacle demonstrates.

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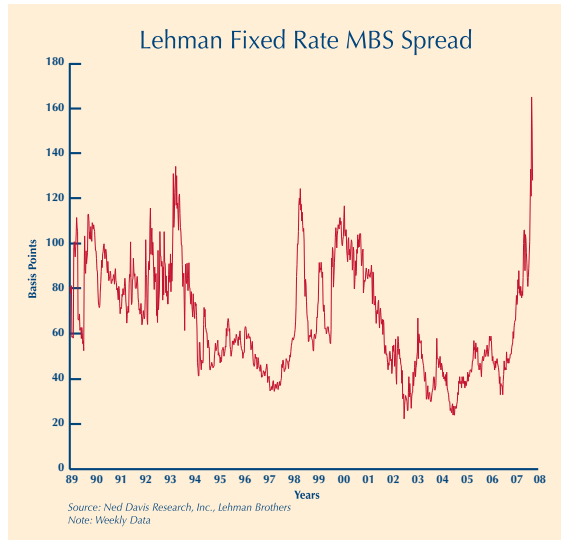
Banks and brokerage houses are attempting to reduce risk on their balance sheets after disastrous forays in structured finance assets. Leveraged participants (primarily hedge funds) are facing increased pressure as these banks and brokerage houses sharply increase collateral requirements. On the other side, investors in some hedge funds are choosing to cash out as their risk preferences decline. The combination of these “risk reduction” efforts on the part of all leveraged participants forces them to “sell what they can” as bids for lower quality product either decline precipitously or disappear completely. However, in the current illiquid environment, selling what they can extracts a very high liquidity premium as bidders tighten the screws.

In the current quarter, this pressure has intensified, and has taken valuations on very high quality bonds to levels not seen in years! In particular, **spreads on highly rated Federal agency mortgage-backed securities (MBS) have soared.** In addition to the factors cited above, interest rate volatility has increased substantially as well, further pressuring MBS valuations. These and other factors have combined to create **what we believe is an extremely rare buying opportunity.**

Chart 3 shows the option-adjusted spread of the Lehman Fixed Rate MBS Index over time. As can be seen, it appears that MBS currently represent very good value. Also, if history is any guide (and we believe it is), attractive valuation levels usually disappear in a relatively short period of time. *That is why we have chosen to increase MBS exposure in portfolios during this quarter despite all the negative trends still coming out of the mortgage/structured finance markets.*

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Chart 3



To be sure, the types of MBS we have chosen to add exhibit very strong underlying collateral characteristics, including adequate seasoning, relatively low loan-to-value ratios, relatively high FICO scores, and geographical diversity. All are guaranteed by Federal agencies, or in some cases, guaranteed by the full faith and credit of the U.S. Treasury. To the contrary, so-called “private label” MBS do not interest us due to the severe credit conditions that still exist in that space.

It is important to recall that for quite a number of quarters, we had positioned portfolios in a very conservative manner due to what we saw as very little reward for assuming incremental risk. This posture has allowed us to, in essence, “provide liquidity” to the markets when many participants have been forced to sell what they can. **In the process, we have taken advantage of an opportunity to buy very high quality MBS assets at very rare, and very attractive, valuations.**

