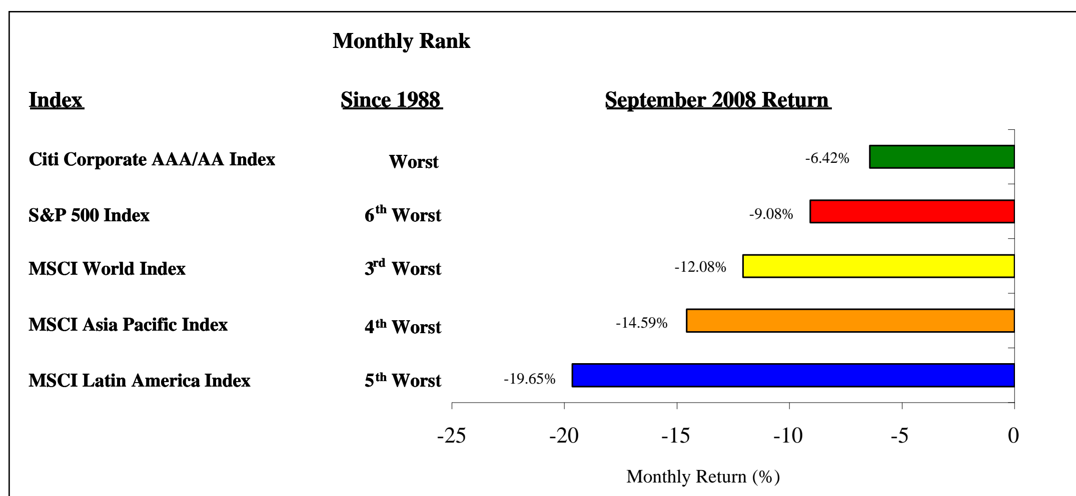
LLOYDS ACTIVE MANAGER UPDATE

2008 will pass to the history as one of the most turbulent years in terms of economy, in particular, the third quarter. By mid-October the credit crisis that originated in the U.S. subprime lending market had spread across global financial markets and economies. We saw changes in ownership in companies such as Bear Stearns, Washington Mutual and Wachovia among others. The summer was hit by the Treasury Department and Federal Reserve announcement to increase Fannie Mae and Freddie Mac's credit line in an effort to alleviate some of the strain caused by the housing crisis. At the end of September, Lehman declared bankruptcy and Bank of America announced the deal with Merrill Lynch. These events pushed the U.S. government to approve a $700 billion bailout plan to help the banking system and prevent the spread of the crisis to other banks and to the global economy. Clearly, one of the first questions that comes to our minds is: did we ever imagine the dimension of the current crisis? The answer is **NO**. While we had positioned the portfolios to weather an increase in volatility, we did not anticipate the depth and breadth of the credit crisis.

Despite the fact that the global economy was expected to enter into a slowdown stage led by the U.S., it was difficult to predict the dramatic events of the third quarter. Equity markets were hardly hit. October was the worst month in many years for some equity indexes. For instance, the MSCI World Index declined 19.04% in October and 12.08% in September, the worst and third worst month respectively in 20 years. Even good credit fixed income securities suffered. Citigroup Corporate Index AAA/AA went down 1.85% in October and 6.42% in September, the 9th worst and the worst month since 1988. The graphs below show the performance for some indexes during September and October. The data clearly illustrates the current moves in different markets and illustrates that investors had no place to hide during those months.

September and October 2008 Return – Monthly Rank



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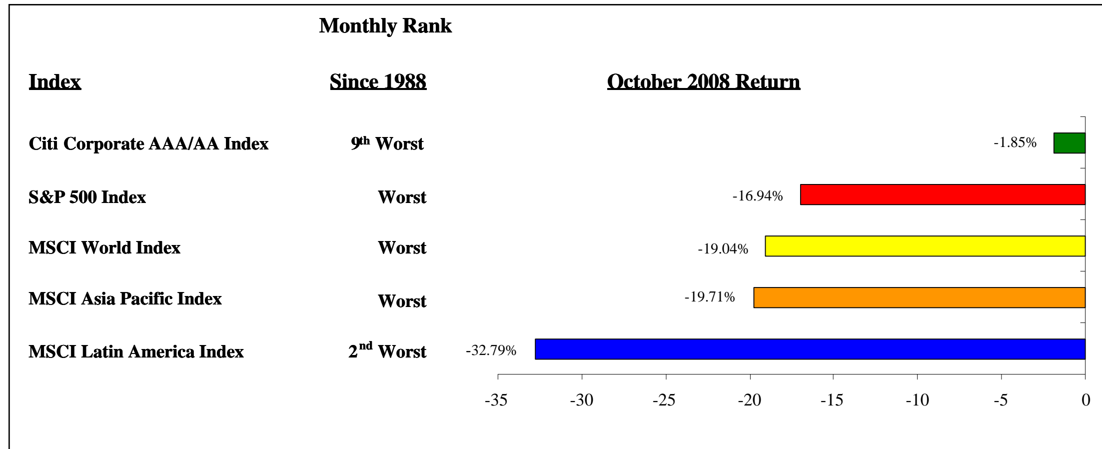

"In investing, what is comfortable is rarely profitable."

Robert Arnott

The negative returns and increase in volatility have led some investors to think emotionally and not rationally. When markets go down, the immediate reaction is to sell. However, they don't take into account the risk of timing the market. This could hurt portfolios' performance dramatically as one cannot predict when markets are going to recover and could miss the upside. Taking the S&P 500 as an example, out of the 15 worst days in the last ten-year period (as of October 31, 2008), 6 occurred in October and 3 occurred in September, that means 60% of the sample fell in two months within the same year. On the other hand, out of the 15 best days during the same period, 4 occurred in October and 3 occurred in September. Those investors that reacted emotionally during these two months and stayed away from the market, missed the upside, limiting the recovery of their portfolios.

Although it is a very hard task, investors that are experiencing this current crisis should be very careful to not limit the recovery of their portfolios. LAM's asset allocation does not give on risky assets but instead, repositions to where the largest dislocation should bring the greatest upside potential.

Times of crisis can bring opportunities over the long term, especially for investors with the ability to distinguish between the temporarily injured and the permanently impaired. As Warren Buffett said: "I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month – or a year – from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

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