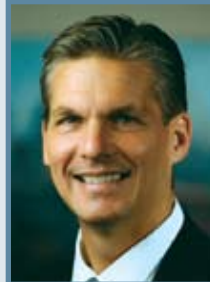


Mr. Market Gone Wild

By Mark Luschini, Chief Investment Strategist



Benjamin Graham has often been called the father of value investing. He was an economist, a business professor at Columbia University and an investor. His book, *Security Analysis*, was published in 1934 and is considered required reading for investment professionals and students of the market. Probably the most famous follower of his disciplined approach to investment management is Warren Buffett.

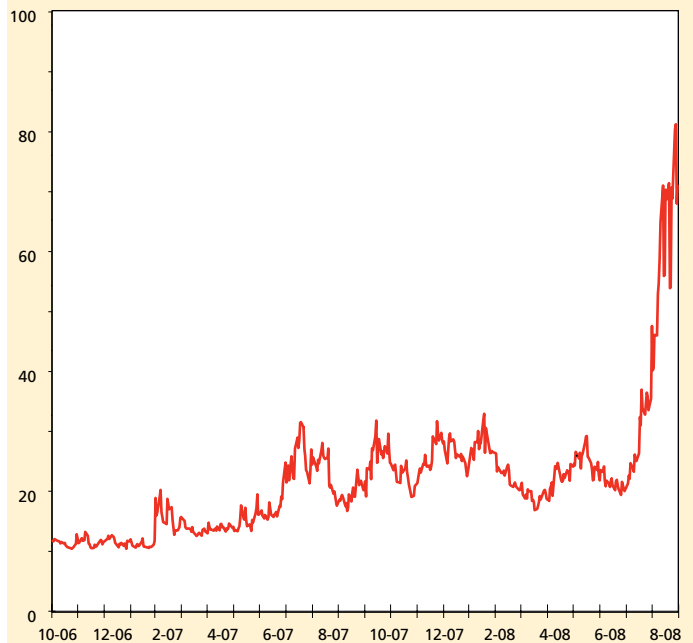
Ben Graham used what has become a famous metaphor called 'Mr. Market' to explain how the stock market works. It may still be the easiest way to understand how stocks are priced and how investors can take advantage of gyrations in the market. The lesson to be learned is captured in one of Mr. Buffett's many maxims, "Be fearful when others are greedy, and be greedy when others are fearful."

Imagine that you own a business and you have a partner by the name of Mr. Market. Your business is a good one, providing a high return on what you have invested. The only thing is that your partner, Mr. Market, is very emotional. Every day, Mr. Market comes into the office and offers to either sell you his share of the business or buy yours. However, if he happens to be euphoric on a particular day, he wants a very high price for his share. On the other hand, if he is feeling down, he is just as willing to sell out for a bargain. It is the same good business it has always been: it just depends on his disposition.

For investors, it is those mood swings that provide great opportunities to participate in the ownership of good businesses. It means you should consider trimming the amount of equity in your portfolio when prices are high and buying equity in the stock market when prices are low. Substitute the academic term 'volatility' for the swings in Mr. Market's emotions and it may offer some insight as to how one should deal with the recent violent moves in stock prices.

Mr. Market's condition in October can best be described as manic-depressive. The percentage move in the S&P 500 Index has, on a daily basis, averaged about 0.80%. However, that percentage jumped to 4.2% in October. Since many investors are more familiar with the Dow Jones Industrial Average, the translation at Friday's level of 9,325 means that the average price change in the index has gone from about 75 to 392 points a day. The only period in which the average daily move in the S&P 500 was higher was during the Great Depression. In just the month of October, the S&P 500 managed to have its second worst week ever (-18.2%), as well as one of its fifteen best (+10.5%).

S&P 500 Average Price-Earnings Ratio 1936 to End of 2007



(Source: Standard & Poors)

Panic helped to increase the volatility, as investors relentlessly sold stocks. For the week ended October 10, the Dow Jones Industrial Average fell over 1,874, as prices retreated to levels not seen in more than five years. On Friday of that week alone, stocks were down at one point 697 points before recovering and moving higher by more than 300, only to close down by 128. The Dow traded in a 1,000 point range on that day for the first time in history. The Chicago Board Options Exchange Volatility Index (VIX) is one barometer of investor fear. The VIX measures projected stock market volatility conveyed by the S&P 500 Index, and generally moves inversely to the benchmark. The VIX rose to reach an all-time high of 89.53, indicating the magnitude of fear that was pervasive during that week. It has subsequently declined to 59.89.

While the stock market should remain volatile for some time, given the still elevated levels of risk in the market, it seems a fair amount of economic damage has been baked into share prices. Mr. Market may have had a maniacal week to close October 31, with gains of 10 – 20% in many indices, but his mood is still generally depressed. Prices have fallen roughly 40% during Mr. Market's despair, inviting us to suggest that investors allocate long-term capital to equities.

Although Mr. Market may stay despondent for some time, opportunities to invest in the best businesses in the world at valuations that, in many cases, have not been at similar levels in more than twenty years seem too tempting to miss.



Stock Market Commentary

By Gregory M. Drahuschak, Vice President

It is difficult to apply an appropriate adjective to describe the stock market in October.

Market volatility was stunning. In the first nine trading days, from its September 30 close through October 10, the S&P 500 fell nearly 28%. The closing low at 848.92 was reached only eleven days later. Intraday 400 – 600 point swings were almost commonplace. The financial sector bore the brunt of much of the early-month losses. In the first nine days of October, the Financial SPDR fell nearly 36% below its September closing level. On September 29, the Dow set its second largest one-day loss of 777.68 points, and then set its second biggest daily gain of 889.35 on October 28. (See Chart A).

Chart A: Just How Bad Was This October

Year	% Change	Month	% Change	October	% Change
1931	(47.1)	Sep. 1931	(29.9)	Oct. 1987	(21.8)
1937	(38.6)	Mar. 1938	(25.0)	Oct. 1929	(19.9)
2008*	(35.0)	May 1940	(24.0)	Oct. 2008*	(18.2)
1974	(29.7)	May 1932	(23.3)	Oct. 1932	(13.9)
1930	(28.5)	Oct. 1987	(21.8)	Oct. 1937	(10.2)
2002	(23.4)	Apr. 1932	(20.2)	Oct. 1978	(9.2)
1941	(17.9)	Oct. 1929	(19.9)	Oct. 1930	(8.9)
1973	(17.4)	Feb. 1933	(18.4)	Oct. 1933	(8.9)
1940	(15.3)	Oct. 2008*	(18.2)	Oct. 1941	(6.9)
1932	(15.1)	Jun. 1930	(16.5)	Oct. 1979	(6.9)

Source: Standard & Poor's. * October 2008 data as of 10/30/08.

Several key internal issues impacted stocks early last month. Perhaps the most important were the forced liquidations of hedge funds, fund of funds and leveraged investment vehicles. Day after day, the end of trading sessions saw huge selling in the final hour. Mutual funds also were nearing the end of their fiscal years, which added to the selling. The sum of all of these factors combined to produce cascading downside in the major averages.

Since 1950, November, on average, has been the second-best month of most years, second only to December. Part of November's relative outperformance stems from the absence of mutual fund tax selling. This year, the absence of other 'artificial' selling enhances the chance for a rebound in November.

Following the heavy selling early last month, the market appeared to be trying to build a base. The bounce off the October 10 intraday low was virtually erased; but, through the retest of the low, evidence was building that the market was gearing up for a recovery try. The calendar merely helps to set the stage for the late-October rally to last longer than for

more than a few days. We expect volatility to continue at a comparatively high level. It is highly unlikely short-term that the Volatility Index (VIX) will fall to normal levels. (See Chart B).

Chart B: October Sector Results

		10-Oct Close	Percent G.L. from 10/10
Energy	XLE	43.40	15.83
Utilities	XLU	25.76	14.67
Healthcare	XLV	24.14	11.10
Industrials	XLI	23.54	5.23
Technology	XLK	15.90	4.91
Staples	XLP	23.60	4.32
Consumer Discretionary	XLY	22.13	1.22
Telecoms	TTH	23.90	1.00
Financials	XLF	15.10	0.66
Materials	XLB	25.68	0.62

Through midday Oct. 31. Source: Janney Montgomery Scott LLC

Despite the rebound from the October 10 low, sector emphasis did not turn totally away from defensive sectors. If the overall market moves higher near-term, the appetite for more economically sensitive sectors probably will improve; but we doubt that even a sharp market rally will turn heads completely away from defensive groups and sectors. (See Chart C).

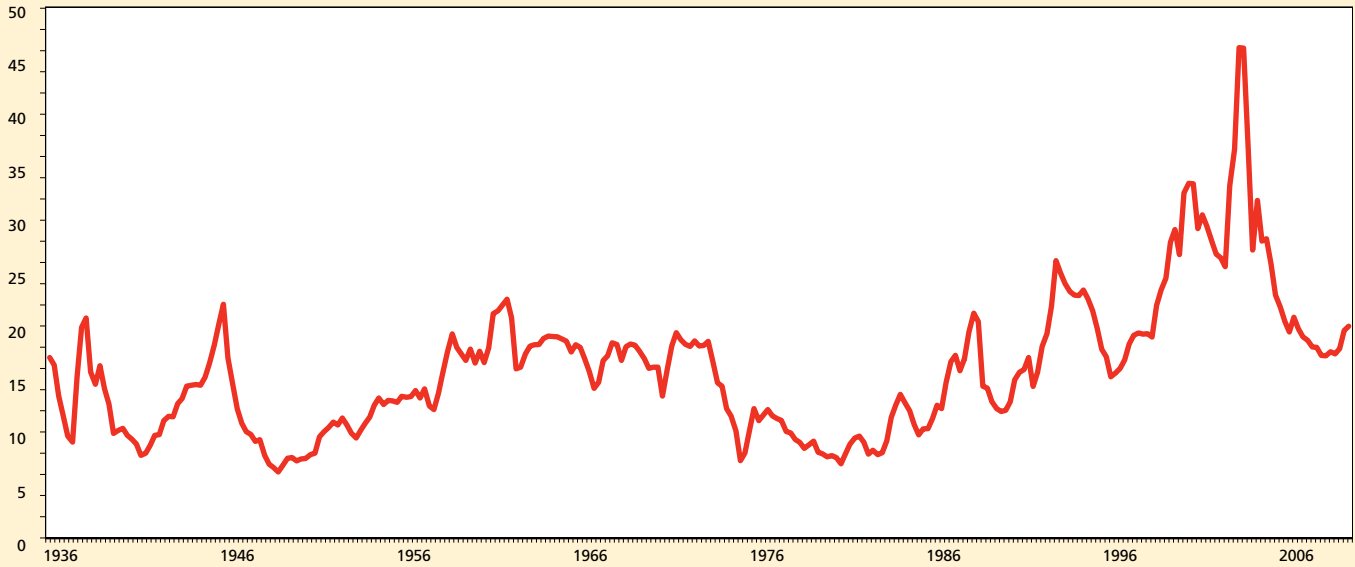
Chart C: October Sector Results

	Percent Change
Telecommunications Services	-9.53%
Consumer Staples	-11.08%
Health Care	-11.81%
Utilities	-11.87%
Information Technology	-17.81%
Energy	-18.01%
Industrials	-18.93%
Consumer Discretionary	-19.27%
Materials	-22.18%
Financials	-22.74%

Source: Janney Montgomery Scott LLC

Earnings, of course, always are crucial in determining stock valuations. Third quarter earnings reports largely have been at or above the expected levels; but this partly is the result of significantly lower expectations. Investors often look at the price-earnings ratio of a stock to assess whether a stock is fairly priced or not. Of course, the problem is in knowing, with a high degree of certainty, what the 'E' portion of the equation

Chart D: S&P 500 Average Price-Earnings Ratio 1936 to End of 2007



(Source: Standard & Poors)

represents. Chart D illustrates the wide variation in the price-earnings ratio for the S&P 500 over the last 72 years.

Based on widely used assumptions of the total S&P 500's 2009 earnings, the market looks very cheap. We suspect, however, that estimates face a significantly downward adjustment. Estimates for full-year 2009 S&P 500 appear to be falling slightly above or below \$70. The question soon will be that if this earnings level is reasonable, what the multiple will be that the market is willing to give to those earnings. Many times, the S&P has settled into an 8-12 times earnings range that often has marked a cyclical low. Assuming \$70 earnings for the S&P 500, this implies a low range of 570 to 840. It may be purely coincidental, but the intraday low in October was 839.40. More

importantly for many investors, trading late in October—and specifically on the 28th—suggested that the market, on a short-term basis, was preparing at least to launch a relief rally.

A record-setting rebalancing required in the S&P 500 appeared to be a significant catalyst for the major gain October 28, which was followed by additional upside through the balance of the month. The absence of large-scale forced selling and some calendar factors, as well as a dramatically oversold market, could combine this month to offer investors relief from the selling onslaught. From a technical viewpoint, should the positive action late last month extend into November and December, 1100 in the S&P 500 is a reasonable target, and we would not rule out the chance it could move to 1200. (See Chart E).

Chart E

2008 Market Data		Prior Close	Last	Change	% Daily	% YTD	% Jan	% Feb	% Mar	% Apr	% May	% June	% July	% Aug	% Sep	% Oct	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
DJ Industrials	.DJIA	9325.01	9309.40	(15.61)	(0.17)	(29.82)	(4.63)	(3.04)	(0.03)	4.54	(1.42)	(10.19)	0.25	1.45	(6.00)	(14.20)	(7.55)	(7.44)	(4.40)	(14.20)
S&P 500	SPX	968.75	964.98	(3.77)	(0.39)	(34.28)	(6.12)	(3.48)	(0.60)	4.75	1.07	(8.60)	(0.99)	1.22	(9.21)	(17.15)	(9.92)	(3.23)	(9.00)	(17.15)
NASDAQ Comp	COMP	1720.90	1727.70	6.70	0.40	(34.86)	(9.89)	(4.95)	0.33	5.87	4.55	(9.11)	1.42	1.80	(12.05)	(17.03)	(14.07)	0.61	(9.19)	(17.03)
SOX Index	SOX	235.06	239.47	4.41	1.88	(41.59)	(12.48)	(0.28)	(5.18)	15.26	4.04	(9.28)	(7.36)	6.45	(19.16)	(18.36)	(17.25)	8.79	(20.53)	(18.36)
Biotech Index	BTK	674.43	683.94	9.51	1.41	(13.04)	(4.72)	(3.66)	2.14	1.10	1.78	(2.76)	17.12	(3.81)	(5.66)	(12.78)	(6.24)	0.05	6.28	(12.78)
DJ Transports	.TRAN	3885.83	3900.11	14.28	0.37	(14.67)	3.97	(4.24)	5.13	8.03	5.21	(9.00)	2.50	0.62	(9.55)	(15.51)	4.67	3.43	(6.71)	(15.51)
DJ Utilities	.UTIL	378.42	378.21	(0.21)	(0.06)	(28.98)	(5.61)	(5.01)	0.31	6.58	2.18	(0.15)	(6.91)	(1.52)	(10.28)	(11.73)	(10.05)	8.74	(17.74)	(11.73)
Volatility Index	VIX	59.89	55.32	(4.57)	(7.63)	145.87	16.44	1.30	(3.50)	(18.82)	(14.24)	34.32	(4.22)	(9.98)	90.75	40.44	13.82	(6.48)	64.47	40.44
S&P Midcap 400	MID	568.49	568.31	(0.18)	(0.03)	(33.78)	(6.24)	(2.00)	(1.14)	7.61	5.14	(7.14)	(1.95)	1.57	(10.83)	(21.86)	(9.17)	5.06	(11.20)	(21.86)
S&P 100	.OEX	464.19	463.48	(0.71)	(0.15)	(32.40)	(6.21)	(4.58)	0.01	4.45	(0.29)	(9.08)	0.49	1.19	(8.01)	(14.72)	(10.49)	(5.32)	(6.47)	(14.72)
Gold ETF	GLD	71.34	71.47	0.13	0.18	(13.33)	10.84	5.23	(6.00)	(4.16)	0.92	4.52	(1.44)	(9.29)	4.11	(15.99)	9.64	1.10	(6.93)	(15.99)
Russell 1000 Index	.RUI	522.47	520.47	(2.00)	(0.38)	(34.93)	(6.11)	(3.27)	(0.84)	4.96	1.62	(8.47)	(1.30)	1.17	(9.81)	(17.82)	(9.94)	(2.37)	(9.94)	(17.82)
Russell 2000 Index	.RUT	537.52	538.28	0.76	0.14	(29.73)	(6.88)	(3.80)	0.26	4.10	4.48	(7.83)	3.60	3.50	(8.10)	(20.79)	(10.19)	0.25	(1.46)	(20.79)

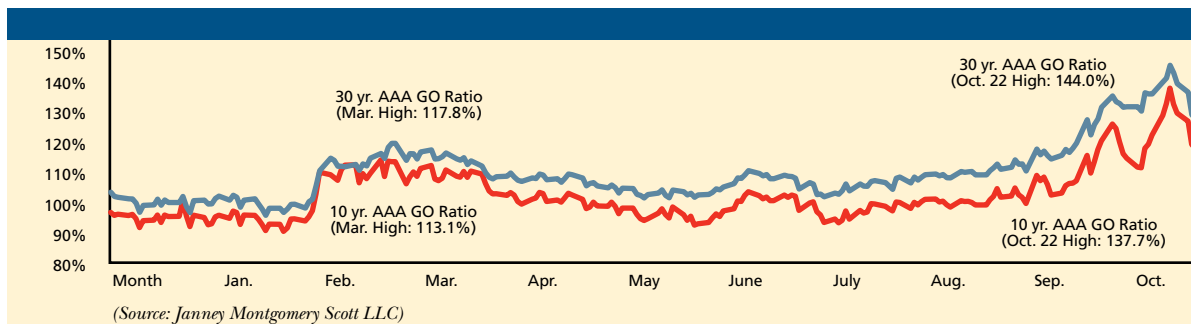
Source: Standard & Poor's

Municipal Market Volatility

By Guy LeBas, Vice President



While many debt investors' attentions remained focused squarely on the credit markets, a second-order fallout from credit troubles hit during late September into October. That fallout impacted prices in a sector that has traditionally been a bedrock component of many portfolios: the tax-exempt municipal sector. In the month of October, the municipal markets experienced the most severe price shocks in decades, driving yields in the sector up to levels not seen since mid-2000. The traditional measure of municipal value, the ratios of municipal bond yields as percentages of Treasury yields, rose to literally unprecedented levels.



These declines certainly contributed to concerns of bondholders; but they also created what was arguably the greatest opportunity for new investment that the last 15 months of the credit and liquidity crunch have brought. Since then, the municipal markets have staged a significant rebound from their lows, largely on the backs of retail and 'real money' institutional buyers, such as banks and insurance companies. That buying reversed a large portion of the sell off which led yield ratios to Treasuries to all time highs on October 22 of 144.0% for the triple A rated long end of the curve, and pushed ratios back down to 128.9% as of October 31—lower, but still very much elevated by any historical standard. Despite this rebound, we believe that the municipal sector, and the stronger credit quality part of the sector in particular, still holds tremendous relative value for the long run. For that reason, we're reiterating our 'buy munis' call we most recently issued on October 23, the day after the sector reached its cheapest levels.

This reiteration of our constructive position on municipal debt stems from several factors, but most critical among those factors is the historical low default experience for municipal debt. Despite expectations of falling revenues and elevated long-term spending needs, the evidence for our assessment of fundamental underlying strength is extremely strong. According to Moody's, the default experience among single A rated municipal issuers is a very slight 0.0084%, approximately 1/80th of the default experience among triple A rated corporates. In addition, recovery rates on defaulted municipal debt tends to be significantly higher than on corporate debt, as the muni bankruptcy process is oriented towards restructuring debt and returning towards solvency rather than selling assets and reducing debt. The impact of this much-reduced

loss given default is significant. According to a landmark study completed by George Hempel, as much as 15% of municipal bonds fell into default during the Great Depression; but accounting for 'credit cures' in which an issuer later became current on payments, and restructurings, recoveries on defaulted bonds averaged 80 – 90 cents on the dollar. Using the lower end of this band and the 15% default estimate, muni investors even during the Great Depression would have realized total credit losses of just 3% on their holdings. Moving away from a historical and towards a fundamental basis, according to S&P, the median municipality with a single A credit rating have just \$1,222 in debt per capita which, even at 12% annual debt service expense, equates to just \$146 of expenses per person. While municipal revenues, both as the result of dropping income property taxes, are likely to fall into fiscal 2009 and perhaps even 2010. The magnitude of the drops are highly unlikely to push more than a handful of issuers into distressed positions as, on average, raising \$146 worth of tax revenues per person will allow a municipality to fund its debt indefinitely.

While many loudly-touted positions on the municipal markets are driven by expectations of a return to historical average ratios, we believe this

is an exaggeration of the likely outcome, for several reasons. First, the effective elimination of the municipal insurance industry and resulting volatility has driven some real money buyers out of the market. In addition, the re-pricing of credit risk suggests a regime where spreads and

ratios in all sectors over the next 5 – 10 years are likely to remain significantly above those over the past five years. The last five years saw an average ratio of triple A long term munis of 97.7%, and it is reasonable to expect, amid this repricing, 'settling' ratios 10% above this level. The final aspect likely to prevent munis from rallying back to 2007 ratios is the fact that the marginal buyers of choice in the sector, namely hedge funds and similar buyers, are virtually extinct and appear unlikely to reemerge, certainly not in a form as strong as they were in early 2008. So while the municipal markets are likely to respond strongly in the wake of a thinning supply overhang (Bond Buyer 30-Day Visible Supply fell \$2.2 billion to \$15.1 billion), that response is unlikely to bring the markets full-circle to pre-September levels. Nonetheless, given low default experience, strong credit fundamentals, and still-cheap prices, we view the high quality municipal sector as one of the most attractive risk/return tradeoffs available in today's debt markets.

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