Marshalla Asset Management, LLC

Registered Investment Advisor

Q3 2008 Commentary: Investment Revisions

By Bob Marshalla
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Introduction

I have already sent you six messages in the past month regarding the incredible financial turmoil that is rocking the whole world's economic system. So rather than write another chapter here, I will use this mailing to focus on the changes in investment targets and cash management procedures that I am making, as well as some thoughts about other investment issues. I do have a few brief comments at the end, nevertheless, about where we are now and what we can expect going forward.

As investors, the best things we have going for us are our long time horizons, our quality managers, and our investment holdings that will for the most part recover eventually. It is still possible I think to be a pessimist about the current state of the economy, while being an optimist about long term investing. But aside from our state of mind, shouldn't we be doing something? Selling everything? Taking advantage of overly fearful markets to acquire some of the best bargains of the century? Ignoring our account statements and going on vacation? Like you, I have fancied of all of these, other than "the going on vacation" part. But I think a major reason most of you have hired me is to be a source of calm and reason at a time like this, and to avoid acting on today's raw emotions.

You have not seen a flurry of trade confirmations in your mail. I am not trying to outguess either the day-to-day unfolding of this financial crisis nor the timing of the recession and bear markets for stocks and commodities. Still, this has been an intense and busy time for me at MAM. I have been keeping up with every twist and turn of the situation, with an eye all the while to the implications it may have for our investment portfolios. Amongst the activities keeping me busy the past few weeks have been:

- Topical reading from the dozens of financial media and investment company sources
- Discussions with lots of other advisors and investment gurus at the annual Schwab conference two weeks ago in Atlanta
- Frequent conference calls presented by our fund managers and other investment spokesmen from leading investment companies (PIMCO, Litman-Gregory, Schwab, etc.)
- Re-evaluating our individual mutual fund and stock holdings
- And most importantly, rethinking our basic investment philosophy, approach and metrics

As I have explained in recent emails, my confidence in our steady, long term investment philosophy and approach remains as strong as ever. But for the first time ever I have concluded that an across the board change in our asset allocation targets is warranted. In other words, our basic investment strategy remains the same, but the metrics for implementing it – in the form of our percentage targets for the various asset classes - will be changed. In addition, I am going to increase the amount of cash reserves held in some portfolios and will consider them to be outside of (i.e., in addition to) our long term asset allocations.

Asset Allocation Targets

The financial revelations of the past few weeks have caused me to revise my assessment of the riskiness of all asset classes. (This topic has been previewed in emails to all clients dated September 27 and September 30.) Going forward, I think equities are and will continue to be riskier than they were previously. Further the ongoing recession is likely to be more severe and longer lasting than I or most observers thought up until 3 or 4 weeks ago. Corporate earnings will be lackluster for at least a year, and possibly a good deal longer. As a result, whatever a person's risk tolerance and risk capacity, his or her targeted level of equities ought to be at least a little lower than it was before. How much lower is an educated judgment on my part, but a judgment informed by extensive exposure to both theory and practice amongst other investment professionals.[1]

Investor Types - I have for the past several years classified all MAM clients into one of seven "investor types". Each investor type represents a different choice along the aggressiveness versus safety spectrum. Your investor type was jointly chosen by you and me early in our relationship based on our assessment of your risk tolerance, risk capacity and investment time horizon. In a few cases when your assessments about the economy's health and the riskiness of equity investing have been notably different from my own, this has also impacted our selection of your investor type.

Investment time horizon is not only about your age. More importantly, it concerns how soon you have to access how much of your portfolio assets. Risk capacity relates to how much you can afford to lose or to put at risk. Risk tolerance is a psychological phenomenon. It is the hardest of all to assess, seeing as most people think they are more or less risk tolerant than they really are when markets are doing very well or very poorly. In light of the extreme market volatility we are now going through, it may be worthwhile for some of us to revisit which investor type fits us best. This will be an excellent topic for us to address in our next in person meeting.

Allocation to Risky Versus Safer Asset Classes - Each investor type is represented by a set of percentage allocation targets for each of five top level asset classes in which we invest,[2] including <u>equities</u>, <u>real estate</u>, <u>commodity futures</u>, <u>alternative investments</u> and <u>fixed income</u>. For example, the targets for the "Moderate Plus" investor type are, based on this month's changes, the following:

Table 1 - Sample Asset Allocation Targets by Investor Type

Investor Type	Equity	Real Estate	Commodity Futures	Alternative Invest.	Fixed Income
Moderate Plus	62.5%	5.0%	6.5%	3.0%	23.0%

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[1] There is longstanding investment theory about how to optimize asset allocations, and there are a number of portfolio optimization models with which I am familiar that purport to do just this. As most of you know, I have decades of experience with quantitative models, but that experience allows me to see their weaknesses as well as strengths. My assessment is that the portfolio optimization models can help us understand the conceptual basis for asset allocation, but are not very useful for finding the actual numbers used to build our portfolios. Thus, we rely on educated judgment. This is not an isolated judgment on my part, by the way, but is referenced to the practical answers offered by other advisors and investment professionals throughout the investment world.

[2] Although I maintain a slate of current targets for each investor type, each individual's own targets may differ a little from the representative numbers shown here due to the amount of time since rebalancing your portfolio and/or other individual factors.

I consider the first three of these asset classes to be the riskier, higher expected return assets classes, and the last two to be the safer, lower return classes. Consequently, a convenient way to represent the aggressiveness versus safety tradeoff for the various investor types is to add the targets for the first three asset classes (equities, real estate and commodity futures) and call this the **"% Risky"** and add the targets for the last two classes (alternative investments and fixed income) and call this the **"% Safer".** Using this method of classification, our current versus new set of asset allocation targets are displayed below in Table 2 for each of the seven MAM investor types.

Table 2 – Previous and New Asset Allocation by Investor Type

	Old Targets		New Targets	
Investor Type	**% Risky**	**% Safer**	**% Risky**	**% Safer**
Very Aggressive	**89%**	**11%**	**85%**	**15%**
Aggressive	**85%**	**15%**	**80%**	**20%**
Moderate Plus	**80%**	**20%**	**74%**	**26%**
Moderate	**75%**	**25%**	**67%**	**33%**
Conservative Plus	**70%**	**30%**	**60%**	**40%**
Conservative	**60%**	**40%**	**50%**	**50%**
Preservationist	**50%**	**50%**	**40%**	**60%**

The table show that the fraction of assets moved from riskier to safer asset classes ranges from 4% of assets for the most aggressive investor type up to 10% for the three most conservative investor types. All but a half percentage point here and there of the decreases in risky assets have been taken from the equities asset class, and all of the increases in safer assets have been added to fixed income. The appendix at the end of this paper shows the full details of asset allocation targets before and after the change for each asset class and for each investor type.

Timing – As I have said several times, the changes I am proposing in asset allocation targets are not an exercise in market timing. I am not trying to get out quick before the market goes down further. The targets are meant to represent our longer term risk and return profiles. So I am not rushing into these changes. Some of the changes will be made in conjunction with the changes in cash reserves that are discussed below. For some of you, the full implementation will not be completed until your next full portfolio review.

A number of you may not want me to change your targets at all, or may want to consider shifting to a different investor type. Others may just want to discuss the matter with me. In fact, I suspect some of you do not even remember what investor type we agreed that you would be. So please let me know if any of these suggestions apply to you!

Investor Type Terminology - Those of you who may keep track of the names I use for investor types may have noticed that the names have been modified. Actually, about four months ago I decided to rename our investor types to make them a little more indicative of how they would be considered outside of MAM. I have simply moved each name a half step up in how aggressive it sounds. So what I had called "Moderate" before has now been renamed "Moderate Plus", and what was called “Moderate Plus” before is now called “Aggressive”. For the most aggressive investor type, I defined the new name “Very Aggressive” to replace the previous moniker “Aggressive”. These changes are nothing more than terminology, but I think they make our names a little more indicative of what most other people in the investment world might be inclined to call them. Also, if you remember agreeing to a particular investor type more than four months ago, please realize the terminology has changed, but your actual investor type has not.

Treatment of Cash Reserves

Other changes I am making have to do with the treatment of cash reserves. (These changes were previewed in an email to all clients on October 9.) A methodology change is that we will now systematically consider all cash reserves to be outside of (i.e., in addition to) a person’s long term asset allocation. A quantitative change is that we are going to size our cash reserves to cover longer periods of time. The effect of these changes will be to make our portfolios a little more conservative, especially for those of us who regularly withdraw cash from our portfolios.

Methodology Change - Until now, I have treated some or all of our cash equivalents as part of the fixed income asset class within our asset allocations. Going forward, <u>I am going to pull all cash equivalents out of the calculations before doing any asset allocation</u>. In other words, I will first compute the level of cash reserves that we wish to hold. This number will be subtracted from total portfolio assets to define Net Long Term Assets. Your asset allocation targets will then be applied to this Net Long Term Assets rather than total portfolio assets.

For example, suppose your portfolio had $1M in total assets, and that we decided you needed to have $50K in cash reserves. Then we would subtract this from total assets to arrive at $950 K in Net Long Term Assets. If your fixed income asset allocation target was 20%, we would allocate 20% of that, or $190 K, to bond funds. At the end of your review you would have a total of $240 K in fixed income overall, inclusive of bond funds plus cash reserves. This is more than the 20% that would be in fixed income if we had counted all cash reserves as part of your fixed income allocation, and in that sense makes your portfolio a little more conservative.

This is not quite as substantial a change in practice as it may appear at first sight, since I have already been doing something like this for many clients on a case by case basis. In cases where I knew a client would be withdrawing a given amount of money soon, such as for taxes, management fees or regular monthly withdrawals, I would set this amount of cash aside, and exclude it from asset allocation calculations much as I am proposing here. But I have not been completely systematic about it, and when I have done it I have been kept the amount of cash reserves pretty lean. Typically I have kept cash reserves on the short side of a 3 to 6 months range or so.

Change of Magnitude - <u>My intention now is to set aside cash reserves for a longer period of time, namely to meet about 6 to 12 months worth of estimated cash withdrawals.</u> We will be making initial changes in the amounts of cash reserves for many portfolios now. In the future, your cash reserves will be regularly replenished at the time of your regular full portfolio reviews, which generally are undertaken two or three times per year. In addition, we will re-build your cash reserves whenever there may be a change in your financial situation, a big new withdrawal or deposit, or simply whenever it becomes clear that you need a larger or smaller reserve.

For those of us who seldom make cash withdrawals from our portfolios, this change will have very small effects. But for those who regularly withdraw significant amounts of cash, there will be a noticeable increase in the amount of assets held in safer asset classes, including cash, at any given time.

Definition of Cash Reserves - My definition of "cash reserves" goes a bit beyond sweep money market funds. It will hereafter also include any holdings in enhanced money market funds (like the Schwab Value Advantage funds) and ultra-short bond funds (like Reserve Yield Plus and PIMCO Short Term). Going forward all of our holdings in such funds will be considered cash reserves that are outside of long term asset allocations.

More on Timing – As mentioned, we are already in the process of making some of these changes in the amounts of cash reserves to hold. For some of you who withdraw sizable amounts of cash, we will make the changes in two or more phases in order to avoid large and abrupt changes. For others, we still need more information about your upcoming cash flow needs, and we have been in contact with you to help refine our estimates. If you would like more specific information about your own portfolio, please do not hesitate to contact us.

Other Investment Issues

I am not planning to make any other across the board changes in investment strategy or procedures at the moment, but as always, there are a number of issues under consideration.

Aside from across the board changes, I will almost certainly continue to make changes in the individual stocks I buy and sell and in the relative amounts of the various mutual funds held in a given portfolio. But most of these will be case by case matters for each portfolio. Among the broader topics under consideration are the following:

- **Emerging markets stocks** - I am still looking for an entry point for introducing dedicated emerging markets equity funds to our portfolios. Emerging markets stocks are, as of this writing down more than 50% year to date. Furthermore, all of this decline has occurred just since last May. While this looks scary, it has eliminated much, if not all, of the "froth" that had built up in those markets after five high-return years.

  This may sound awfully contrarian, but I am much more interested in buying such funds now than I was when they were really hot. Valuations had gotten a bit out of hand after five years of rapid increases in stock prices. Still, I am not quite ready to pull the trigger. To enter at this moment could be like trying to "catch a falling knife" as they say. Once the markets settle down a bit, I expect to initiate positions in emerging markets stocks, in amounts likely to be between 5% and 15% of equities[3].

- **Foreign currency hedging –** I completely sold out our developed markets bond funds last summer, but we still hold a developing markets currency fund in just about everyone's portfolio. In addition between a quarter to a third of our equity holdings are in foreign markets.

  The U.S. dollar has been strong for the last three months or so, especially versus the euro and pound. While our developing markets fund has fared better than the developed markets fund that we sold, it has still fallen in value in the past three months. But looking over a longer horizon, the U.S. continues to have a huge annual and cumulative current account deficit, and I think that downward pressures on the dollar will continue as a result. I don't think the U.S. dollar has much reason to weaken against the Euro or other European currencies, so my plan is to stay with the developing markets fund that we currently own and to stay out of the developed markets fund we recently sold, at least for now. The fund we are in has exposure to 29 developing market foreign currencies.

[3] For more of my feelings about investing in emerging markets, please review my commentary form last quarter.

- **Commodity futures –** After 5 ½ years of spectacular performance, commodity futures have crashed in the past three months. Oil is not the only commodity whose price has fallen sharply; virtually all of them have. Even aside from the current wild economic conditions, commodity futures are a notoriously volatile asset class. What has happened in the past three months is well within the range of expectations, and I expect to simply bring them back to target the next time I rebalance each portfolio.

Conclusion

Evidence that the problems in the housing market were creating havoc in the financial sector first became clear in July of 2007. The 15 month period since then has been difficult and nerve wracking. But the last four weeks have ushered in a phase beyond just about anyone's worst case scenario. This has been by far the most harrowing period of my time in the investment management business. The crisis has gone beyond worries about a severe recession to one of the continued viability of the whole financial system.

At the crux of it all is the freezing up of the credit markets. If there is such a loss of trust that no one is willing to lend to anyone else, then the whole economy, not only the financial sector, would be brought to its knees. The outcome to be avoided is the spilling over of the financial sector woes into the "real" sectors of the economy so that we lose real employment and real economic output, not just a few banks and other financial companies.

So unfreezing the credit markets has become the rightful focus of policymakers worldwide. The current strategy is based on injecting new capital into the major companies and guaranteeing inter-bank loans. Whether or not this is enough to do the trick I do not know. But eventually they must succeed and they will succeed, even if it takes numerous iterations and false starts. And when they do, the credit markets will stabilize and some sense of normalcy will set in.

The stock market is really the tail of the dog here. If the credit markets get to functioning again, then corporate earnings will eventually recover, even if not until after a longer than expected recession. And if corporate earnings recover so will stock prices. You can bank on it (though that phrase doesn't have the same comfort it used to). I expect this to be a long and severe recession. And stock prices are not going to snap back in just a few months. The S&P 500 fell 45% in a year and a day through last Friday. It will take an 82% increase to get back to the all time high that it reached on October 9, 2007.

We have pulled our horns back in a bit, but our basic long term investment strategy remains the same. As I have said many times, it is a strategy that requires faith and patience. Our faith and patience are being tested now like never before (unless you were alive in the 1930's). But if you believe like I do that the economy – not just here, but worldwide - will recover, as it has in the past from every war, depression, financial failure, terrorist attack, everything, for the past century and more, then keeping with our strategy of staying invested in diversified asset classes for the long term makes as much sense as ever.

Best Regards,

Bob Marshalla
Your Financial Advisor

APPENDIX
NEW ASSET ALLOCATION TARGETS

New Asset Allocation Targets - Oct 2008

% Risky	Investor Type	EQ	RE	CF	AI	FI	% Safer
85%	Very Aggressive	72.5%	5.5%	7.0%	2.0%	13.0%	15%
80%	Aggressive	68.0%	5.0%	7.0%	2.5%	17.5%	20%
74%	Moderate Plus	62.5%	5.0%	6.5%	3.0%	23.0%	26%
67%	Moderate	56.0%	4.5%	6.5%	3.0%	30.0%	33%
60%	Conservative Plus	49.5%	4.5%	6.0%	3.0%	37.0%	40%
50%	Conservative	40.5%	4.0%	5.5%	4.0%	46.0%	50%
40%	Preservationist	32.0%	4.0%	4.0%	5.0%	55.0%	60%

EQ = Equity, RE = Real Estate, CF = Commodity Futures, AI = Alternative Investments, FI = Fixed Income

Previous Asset Allocation Targets - July 2008

% Risky	Investor Type	EQ	RE	CF	AI	FI	% Safer
89%	Very Aggressive	76.0%	5.5%	7.5%	2.0%	9.0%	11%
85%	Aggressive	72.5%	5.5%	7.0%	2.5%	12.5%	15%
80%	Moderate Plus	68.0%	5.5%	6.5%	2.5%	17.5%	20%
75%	Moderate	64.0%	5.0%	6.0%	3.0%	22.0%	25%
70%	Conservative Plus	59.5%	5.0%	5.5%	3.0%	27.0%	30%
60%	Conservative	50.5%	4.5%	5.0%	4.0%	36.0%	40%
50%	Preservationist	42.0%	4.0%	4.0%	5.0%	45.0%	50%

EQ = Equity, RE = Real Estate, CF = Commodity Futures, AI = Alternative Investments, FI = Fixed Income