TD CAPITAL MANAGEMENT LLC
INVESTMENT COUNSEL

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Portfolio Matching Process: More New Stuff and a Personal Invitation

In human affairs of danger and delicacy successful conclusion is sharply limited by hurry. So often men trip by being in a rush. If one were properly to perform a difficult and subtle act, he should first inspect the end to be achieved and then, once he had accepted the end as desirable, he should forget it completely and concentrate solely on the means. By this method he would not be moved to false action by anxiety or hurry or fear. Very few people learn this.

East of Eden, John Steinbeck

A year ago the S&P 500 (proxy for the stock market) was around 950. Today it's bouncing around 1100. A year ago we were concerned about the future of capitalism and beginning to challenge the economic and financial models that we had all believed in and relied on for many years. Today we are modestly reducing our equity exposures because current levels may be a little higher than indicated by earnings and asset values.

Before we get into the "meat" of this communication, I need to make a confession: A couple of years ago I was beginning to get bored and a little lazy due to some complacency because everything was working so well. TD Capital has been around since 1996. The late 90's were characterized by fantastic returns in the stock markets – led by techy stuff and growth-oriented businesses and industries. We fought to maintain our focus on diversification and cash-flow planning in an environment where big stock returns were pulling us toward more and more risk.

The bubble burst in early 2000 and continued losing air for about 3 years. We maintained our discipline; our allocations to bonds, real estate, value stocks and others mitigated the losses resulting from the frightening declines in tech and growth-oriented stocks.

2003 through late 2007 created my complacency. Everything went up (and up and up). I wrote a newsletter during this period called "The Big Easy" suggesting that our discipline and focus on diversification were not reaping significant benefits because the rising tide of all the sectors and segments made investing a rather easy project. We just sat back and enjoyed the ride.

Along came late 2007 and we were (almost literally) shaken out of our complacent attitudes. The various stock markets and segments began a gradual and somewhat normal descent that built to an alarming "crescendo" from about Labor Day 2008 through early March 2009. The difference between this decline and the market declines of the early 2000's is simply that diversification did not work this time – it did not protect our portfolios from participation in the financial meltdown. The easy times where the gains were across the board were followed by this frightening period where the declines affected virtually every segment and sector of the various markets – equity (prospect-based) as well as bonds (liquidity).

5100 Poplar Avenue • Clark Tower 30th Floor • Memphis, TN 38137 • Phone: (901) 681-0021 • Fax: (901) 842-2824
www.tdcapitalmanagement.com
a Registered Investment Advisor

My confession is that I have appreciated the intellectual and academic stimulation and learning opportunities afforded by this crisis and the seeming failure of existing paradigms in providing protection. I have read more books in the last 15 months than in the last several years. I went to school at Stanford to discuss and debate with the academics that hypothesize and research our field. John Harrell went to the University of Chicago to do the same. We have read and read research papers, journal and magazine articles, attended conferences and webcasts. We have challenged our friends at Vanguard, Goldman Sachs, and iShares to provide us with new tools. We have had brain-storming sessions designed to take the new information and apply it to our portfolios.

We are extremely pleased with the results and very confident of the efficacy of our new portfolio models: new ways of looking at diversification; new approaches to the liquidity side of our portfolios; the installation of a very sophisticated system to increase or decrease the "throttle" of our portfolios as the effects of negative serial correlation produce risks and opportunities.

That was a little longer introduction than planned, but hopefully gets you thinking about where we are related to our clients' portfolios. The application of all this new thinking and research has awakened our creative spirit and presented exciting challenges in our work.

The next step in our efforts was to shift from the pure investment management part of our work to concentrate on matching our clients and their needs with the appropriate portfolio as they (and we) seek to satisfy their goals and objectives, all constrained by the simple facts of life – reasonable withdrawal rates, taxes, stage of life, etc.

We have developed a new system to attack the problem of model portfolio selection: proportion of equities and prospect-based holdings; proportion of liquidity-based assets; utilization of other assets (house, pensions, social security, etc.); recognition of stage of life issues, liabilities, needs to be funded and so on.

This system has required us to develop and use new terms and concepts to describe and apply our work:

- Risk budgeting
- Investable assets, actual assets and implied assets
- Actual liabilities and implied liabilities
- Defining and funding goals and objectives
- Life-strategy balance sheets
- Equilibrium allocations
- Cash-flow coverage ratios
- Equity return forecasts
- Hurdle rates
- Strategic inflection points
- Goal prioritization
- Base and maximum portfolio cash-flows
- Relevant age and age-weighting
- Discretionary cash-flow and discretionary wealth
- Objective / Portfolio or asset matching
- Characterization of objectives, assets and liabilities
- Equity (prospect) base amounts

Many of these terms and concepts are new, and merely listing them doesn't shed much light. The process is something that we have been working on unconsciously for years, and consciously for several months. It's ready to go and to be put to use for the benefit of our clients. We do not plan to describe it in full detail and distribute it – we developed it, it is for our clients, we really don't want to publicize or expose our work to folks outside the family.

This, then, is an invitation. Please give us a call and establish a time to visit with us in the next two or three months (in person or by phone). We plan to put our process in place effective for the first quarter of 2010, and would like to discuss its application to our clients' specific situations prior to implementation. There is no rush. We just want to have your input because this is about you – it's about recognizing you and who you are and applying this process as we work together toward accomplishment of your financial goals and objectives.

God Bless,

Doug

Douglas Smith, cpa/pfs
Managing Director, Chief Portfolio Strategist