TD CAPITAL MANAGEMENT LLC

INVESTMENT COUNSEL

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2008: A Turbulent Year in Review

Invisible chains which bind together all these discordant objects. Adam Smith

The prevalent stock market indexes were down somewhere between 30% and 40% for the year just ended. Interest rates began the year at historically low levels and *declined* significantly by year-end (after dramatic tumult in-between). Commodity prices rose and fell. Housing prices continued to slide from bubble-like highs in the first half of the decade. Mortgage rates declined - but due to a general slowdown in the housing markets – not much activity was reported in the mortgage arena. Inflation as measured in a general sense was present, but at a rather small rate of increase. Unemployment rates rose (or conversely, employment rates declined) as an economic slowdown was realized.

Meanwhile, the most pressing fear as we began 2008 – extremely high and rising oil and gas prices – waned during the last half of the year. Last spring the great concern was rising energy prices and their expected effects on worldwide economic activity. Oil prices declined precipitously, but economic activity fell instead of the compensating upward. 2008 was, to say the least, an interesting year.

One of the purposes of this paper is to take a fairly quick look back at 2008 and some of the financial and economic realities that caused the turbulence and unrest. Another purpose is to set some thoughts in motion – the idea that the serious declines in the equity markets in 2009 may not be all that pertinent or important to long-term investors; the notion that investors need to turn back to the basics of sound portfolio and financial management for comfort and security in the face of the rather unprecedented events and nuances of a very turbulent and gut-wrenching period of time. Finally, we will take a forward viewpoint and give some thought to what we learned from all this tumult and noise.

2008 in Review

2008 was the year that we began to "pay the piper." For a number of years we have been spending more than we probably should, in many cases more than was coming in, or deficit spending. This phenomenon occurred at the government, business, and individual/family levels. Our governments borrowed and spent, spent and borrowed. Our businesses spent on promotion, executive compensation, and stock buy-backs. Many also took on significant risk but, in general, did little to develop or invest for the future. Families and individuals borrowed on credit cards and mortgages to buy "stuff" and houses. Spending more than was coming in and ignoring the necessity of saving and investing for the future created a level of risk at every level that proved to be difficult and perhaps inappropriate.

The stories of sub-prime mortgages, credit-default swaps, extreme leverage, and the collapse of financial institutions are getting to be old hat, but will remain in our vocabulary and vernacular for a long time. A very large number of bad decisions were made. 2008 will be remembered as the year when these separate but related issues created a perfect storm that re-

5100 Poplar Avenue • Clark Tower 30th Floor • Memphis, TN 38137 • Phone: (901) 681-0021 • Fax: (901) 842-2824

a Registered Investment Advisor

wrote the roster of financial companies and institutions and saw a tremendous amount of emotional reactions by investors - resulting in extraordinary negative volatility in the various equity and bond markets.

Portfolio Performance versus Volatility

If we put a few bucks in an insured savings account at a bank, we are confident of at least two things: That we will get a very low amount of interest on this "investment" (low expected return), and that our money will be there and intact if we go back to the bank to recover it. As Mark Twain said, "I am more concerned about the return OF my money than the return ON my money**."** That, then, is the theory of investing applied to putting some money in low return, low risk savings accounts.

When we invest in the stock market we also know a couple of things: that our "expected" return is significantly higher over the long-term than the expected return from a savings account, and that we have subjected our portfolio to significant volatility over shorter periods of time.

So, here's the question: which is better? The answer is neither, but both have some pluses and minuses. The real answer is inextricably attached to the notion of the appropriate investments or mix of investment vehicles with the needs, objectives and underlying "attitudes" of the investor. If we're talking about short-term money, then short-term low-volatility investments make sense. If we're talking about long-term, permanent investments, then the intermediate volatility is irrelevant to the actual performance of the portfolio and can make sense. For most investors an appropriate mix of the two investment methodologies is often the "best" answer.

A recurring theme in our client communications for 2009 will be this bifurcation and juxtaposition of *performance* and *volatility*. Performance should combine investment return numbers and results with attainment of reasonable long-term goals of the investors. Volatility is a natural consequence of holding investments subject to variability. The timing and extent of the volatility must be considered in light of the investors' needs, as well as the attitudes or potential emotional and behavioral reactions to significant and unexpected periods of volatility.

Basic Comforts

Way back in September (or October) when the conditions in the financial markets and world-wide economy looked particularly bleak, the TV guy who yells about stock markets and so on apparently became very popular and appeared on CBS' *Sixty Minutes* and NBC's *The Today Show*. I wasn't fortunate enough to hear him scream out his messages, but I understand that he told everyone that if they needed any cash from their portfolio over the next 5 years, they should get out of the stock market - as if all our money is attached like a chain and it's an all or nothing proposition.

A couple of our clients called to ask about this and I suggested they look at our notes from all our previous conversations and everything we have ever communicated to our clients and see that we have ALWAYS promoted an estimation of cash needs for the ensuing five years and have ALWAYS promoted the idea of keeping that five-year funding completely out of the equity markets – bonds, CD's, near-cash, money markets instead.

So, here are the basics -

- Provide for cash flow needs for five years OUTSIDE of the volatile equity markets.
- Diversify ALL portfolios as much as possible.
- Keep costs inside a portfolio as low as reasonable.
- Pay attention to tax-efficiency where applicable.
- Control expenditures – keep portfolio withdrawals at or below 5% of the portfolio balance per year. Use a rolling average of the portfolio balance so that equity volatility doesn't create wide swings in cash flow.
- DO NOT let short-term volatility result in an emotional reaction that changes a portfolio's objectives from long-term, permanent to short-term, reactive. Volatility is a component of long-term portfolio performance. Emotional reactions and market-timing moves are related to the volatility, not to the attainment of goals and objectives.

What We Learned and What to Do

The discovery of an immense chain of the most important and sublime truths, all connected together by one capital fact [gravity], of which we have daily experience. Sir Isaac Newton

One of our clients who is a big-shot at a big-shot company, and who was trained as an economist called on one of the really wild days last fall. He opened the conversation with the question: "Man, have you ever learned so much in such a short period of time?" The silver lining in the dark clouds may just be that we have been given the opportunity to know things that we could not have known prior to the events of the last 18 months or so.

The challenge is to know what we now have the capability of knowing and structure our financial lives and portfolios to benefit from our increased knowledge.

We have spent considerable time over the last few months with some very smart folks from Vanguard, Barclays, and Goldman Sachs. We have challenged these folks to help us better understand their products so that we can apply our new found (and difficult) knowledge to the management of our clients' portfolios.

The product of these conversations will result in some important changes to our model portfolios. We will be explaining these in more detail in our next communication, but suffice it here to say that we plan to make several enhancements to our (your) portfolios:

- Specifically in the non-traditional or satellite strategies section of our portfolios we will be adding a modicum of active management through utilization of one of Goldman Sachs mutual funds.
- We will be including another Goldman fund in the category of "absolute returns" in an attempt to enhance returns and increase diversification while still providing a measure of lower volatility positions for unexpected cash needs.
- We plan to "de-complicate" and liquefy our fixed income allocations to further enhance availability for unexpected liquidity events as well as adding an intentional allocation to certificates of deposit for ultimate stability.
- Finally, we will be allocating a measure of holdings to a concept we reference as a "pressure

-valve" or "throttle" to all our portfolios.

We look forward to communicating with you about the portfolio enhancements, the developments of some of the thoughts and notions mentioned above, and, as always, we are attuned to your needs and look to you for information, feedback and concerns.

It's going to be a tough period of time for those less financially fortunate than we. Give some thought to helping where you can.

How selfish soever man may be supposed, there are certainly some principles in his nature which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing except the pleasure of seeing it. Adam Smith

May God Bless You and Yours.

Respectfully submitted, 8 January 2009

Doug

Douglas Smith, cpa/pfs
Portfolio Strategist, Chief Investment Officer