Chartwell Consulting

CHARTWELL VIEWS

October 10, 2008 **Current asset allocation ideas** *First in a continuing series*

Interesting Times

"May you live in interesting times" is reputed to be the English translation of an ancient Chinese proverb and curse. Scholars doubt its authenticity. One theory is that it may be related to the Chinese proverb, "It's better to be a dog in a peaceful time than be a man in a chaotic period." I think the latter pretty much sums up how investors feel about 2008 in general, and the past few weeks in particular.

It was unfortunately ironic that earlier this year we chose to write a little piece on the Panic of 1907, following the government orchestrated take-under of Bear Stearns (see 1Q08 Chartwell Review). Events since April have followed an eerily similar path, naturally adjusted for the fact that the country and the world are in very different places than 101 years ago. Recent events, culminating with the last four unprecedented weeks, have changed the nature of American finance to a greater degree than any other single period since WWII.

A series of ad hoc government interventions, in response to an extreme global crisis of investor and creditor confidence, together with the inevitable feedback loops, promises to completely alter the face of domestic mortgage finance (which is at the heart of consumer finance), domestic investment banking, and the very structure of American financial markets. In the process, our government imprudently "sent a message" that you better be very careful *what* you own, because even the shortest-term senior debt of select companies (Lehman) can be made worthless overnight, with no chance for recovery or collection.

The triad of Wall Street, Main Street and Constitution Avenue is being reshaped. The former is descendant, the latter is ascendant, and Main Street is caught in the crucible. Further, this is taking place on a global stage, where we have been able to definitively observe foreign governments' direct impact on our domestic monetary and fiscal policy at the highest level. The US investor nation just doesn't seem to be standing astride the world in quite the same way it did a few short years ago, at the same time that (or perhaps because) global politics and global commodity markets are vexing.

We are as shell-shocked by what's been going on recently as the next person. But, we've been at this long enough to know that hope is not a strategy. In times like these, one has to step back, assess their individual situation as dispassionately as possible, assemble a sound core of fact-based market insights, and "work the problem."

First Things First

If you haven't already done so, contact your custodian or administrator, and clarify precisely the core strategy, and complete credit ratings profile of the money market mutual fund that all of your accounts' excess cash balances are swept into and held pending reinvestment. Confirm the fund in question is a "2a-7" fund, is rated AAAm by all major credit rating agencies, and that the sponsor has placed the fund in the recently announced Federal guarantee program.

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Ensure that your sweep fund is either a "government money fund" (safer) or a "prime money fund" (safe, but not as safe). The rest of the details, like current yield, total return over the last year, and expense ratio, are important to sort out, but only after you've confirmed that your cash is being held in the safest manner available to you.

Second, sit down and calculate the **total** amount of distributions your pension plan, endowment, foundation, or capital investment pool will be *required* to distribute, during the 16 months from now through January 31, 2010. Very cautious institutional investors will extend this distribution calculation to include the months through the close of their 2010 fiscal year. That would be 21 months for an endowment with a June 30th year-end.

You may choose to reduce this "gross distributions" amount by the contributions you are already firmly committed or scheduled to make during the period, in order to come up with a lower "net distributions" figure (but, we prefer using the higher number, just in case for some unforeseen reason you decide not to make the contributions).

Third, liquidate sufficient investments to build up your total cash on hand, sitting in that safe money market mutual fund, equal to the total of expected distributions. Your Asset Pool or Plan now has zero liquidity concerns through at least next year. Your remaining asset allocation issues relate to the inherent trade-offs between short-term mark-to-market volatility and long-term total return.

From where should you source this additional core short-term liquidity (assuming it's not already in place)? We recommend, in order of preference, from developed market international equity managers, U.S. core bond accounts/funds, and U.S. small cap accounts/funds. Not great choices, we know, from a "buy low, sell high" perspective, but you've got to do it.

Step 2

Having put your near-term liquidity issues completely to rest, its time to decide whether you can still afford to be a "long-term" investor. This isn't a trivial question. Many enterprises cannot afford, in a legal or operational sense, for their plan assets or investment pools to be exposed to much more downside mark-to-market risk, even if losses to date are completely unrealized mark-to-market. This might be due to collateral valuation arrangements backing outstanding bond issues, the impact on calculations for necessary future distributions to school operating budgets, or the impact on upcoming actuarial calculations of future pension plan contributions, to name a few. For whatever the reason, some investors simply aren't in a position to bear the risk of further short-term mark-to-market losses, regardless of what future long-term return prospects may be. Their plan's unique individual circumstances dictate this conclusion.

Those that urgently need to disengage, because their future loss threshold has been reached, should do so without regard to market timing. Don't wait to "sell the rallies," or leg out by selling equal amounts over the next 3-6 months. Just sell your risk assets, including any bond funds with concentrations of credit risk-oriented paper.

Put 25% of proceeds in the money fund, and split the remaining 75% equally between portfolios/funds full of AAA mortgage-backed securities (primarily bonds that are agency-backed), and portfolios/funds concentrated in long-dated Treasury Inflation-Protected Securities. Agency mortgages are really government bonds with a positive spread, and will be favorably impacted by the Fed's $700B buyback program. As for TIPS, we aren't especially concerned about rising interest rate and inflation concerns during the recession we're in, but you never know. TIPS bond prices were hit very hard in September, and now offer decent yields for those portfolios that must completely disengage from the risk markets.

We hope none of our clients are forced to make this call. From the perspective of *future* long-term return maximization, we do not recommend this "nuclear option." But, it is the only way to surely avoid more unrealized mark-to-market losses.

Where we are

Governments around the world are taking extraordinary steps to try to keep the financial sector from unraveling, and taking the "real economy" down with it. But the U.S., Europe and Japan were already in or on the verge of recession prior to the financial scares of the past few weeks, and the ongoing deterioration of credit availability bodes ill for the economic outlook. While the collective liquidity and investment actions by policymakers are major steps in the right direction, and will ultimately be taken well by market participants, it makes sense for investors to avoid overestimating the likely benefits. Given the pain and false starts, the healing process will take time.

The biggest risk in the current environment is a run on the financial system, in which investors and depositors cause otherwise sound institutions to fail by simultaneously demanding their funds. Government actions to stem this exaggerated liquidity preference are heartening, and we expect we've not heard the last word on the subject. This week's "UK model" of guaranteeing bank deposits and injecting capital directly into banks will likely be replicated elsewhere. Although we expect the unfolding global recession to be severe, history shows that equity markets have bottomed well before the end of most post-war recessions.

Traditional measures of stock valuation – earnings multiples, price-to-book, price-to-sales, etc. are in territory that on paper would typically justify not just increased exposure at this time, but instead a sizable *overweighting* to stocks compared to an investor's current strategic targets. The same can be said for leveraged bank loans, non-agency mortgage securities, and even junk bonds. However, we know that valuation tools become moot if the financial system does not function, since that can by itself cause precipitous declines in book value, sales, and earnings. We've all observed that in the banking sector, and this *could* spill over to the commercial and industrial sectors. The Federal Reserve's establishment of its new Commercial Paper Funding Facility will help, in time, to minimize the negative feedback effects.

What we recommend

Our bottom line is that more support programs for the financial system (more bank equity capital, and broader depositor guarantees) will likely be a pre-condition for increased investor risk-taking to be rewarded on a lasting basis. The world's stock markets are in full capitulation mode at present, and price/value doesn't matter. It's not quite time to be in a hurry to reload, as markets normally bump along their bottoms for months. That is exactly how the end of the prior bear market played out from September 2002 through March 2003. However, long term investors who have their medium-term liquidity needs buttoned up now need to plan their attacks, *for staggered execution post-election through the end of the first quarter*. In this next phase, it will be important to **over**weight high beta risk assets. Buffet's concept of "being greedy when others are fearful," is an important one.

We know that asset pools have little in the way of liquidity, what we call spare ammo, for this process. Absent fresh contributions, which will be in very short supply, the source of funds must necessarily be from your most conservative bond accounts. On this point the math is clear; you can't overweight high beta risk assets without underweighting low beta assets.

Domestic Stocks

Globally, the world's blue chip stocks are on sale. Check out GE (9x PE; 6.5% div. yld), Vodafone (9x PE; 9.5% div. yld), and Dell (10x PE), plus any number of household names you can think of. The MSCI World index is trading at a trailing PE of 11x, for the first time since 1984.

The domestic market's irrational pessimism is exacerbated by a lack of confidence in forward earnings. Earnings of the S&P 500 stocks *have* sharply underperformed quarterly expectations for the past three quarters (4Q07, 1Q08, and 2Q08), and are poised to do so for at least the next three.

Time Period	Dec. '07 Operating Earnings Forecast	Sept. '08 Operating Earnings Forecast	Slippage
4Q07	$20.19	$15.22A	*-24.6%*
1st H '08	48.43	33.64A	*-30.5%*
2nd H '08	52.81	43.96E	*-16.8%*
1st H '09	51.77	49.26E	*-4.8%*
2008	101.24	77.60E	-23.4%
2009		104.15E	????

On its face, this looks terrible. The current year's operating earnings may struggle to surpass $72/sh, compared with nearly $83/sh in 2007. If the consumer discretionary and financial services sectors don't rebound (they will be off 30% and 80%, respectively, in 2008), next year will fall far short of what are still lofty expectations.

But, here's the other side of the coin: At the end of 2002, following a crushing bear market (with investor sentiment in the dumps), the S&P closed December at 880, and trailing operating earnings were only $46/sh. After a great 2003, the market was at 1112 as that year's earnings rose to only $**55**/sh. If 2009 is exceptionally weak, S&P operating earnings will come in around $**70**/sh. At a PE of 18x, that works out to an index level of 1260, *which is 38% above yesterday's close.*

In August 2002, we were a bit early in promoting an overweighting of US large cap stocks, with at least some of the delayed market rebound caused by the uncertainty surrounding our country's preparations for war. We seem to be approaching a similar point in time, having now retraced over 70% of the prior bull market advance. As soon as we get past the elections, and have some evidence the massive collection of policy actions are beginning to take hold, we recommend significantly **over**weighting US large cap stocks, especially blue chip growth stocks.

International Stocks

A number of countervailing dynamics are interacting in the international equity markets, which have otherwise become attractively priced.

- The majority of developing markets – England, Europe, and Japan, are experiencing the same recession as in the US, deferred somewhat in time. Earnings growth prospects in these regions are highly questionable.
- Large financial sector weightings in these countries could magnify the impact of the credit turmoil.
- Additional negative currency effects may add to local market weakness in developed countries, if the US$ rally versus the Euro and Pound continues.
- This year's rapid shedding of risk has taken down emerging markets stocks much more sharply than any other equity asset class. What rose the highest has been sold down the hardest. Emerging markets valuations are down to 10x PE, and trading through those of developed markets. This is back to relative levels not seen since 2003, despite expectations of 5-10% EPS growth in 2009. Further, currency effects should be collectively positive in those markets.

When equity markets rebound, we expect high beta EM to share the lead with US blue chip growth stocks. Taken as a whole, we favor moving to a higher strategic allocation to emerging markets, at the expense of developed market exposure. This can best be accomplished via the engagement of a dedicated EM manager/fund.

Domestic Bonds

The domestic bond market has been blown apart by a combination of unexpected bankruptcies and take-unders, rapid deterioration of mortgage pools, and anticipated, but heretofore unrealized, problems in the corporate loan and bond sectors.

US credit spread metrics are at moderate-to-severe recession levels, with long-dated BBB industrials now trading at 350bps over Treasuries, a level last seen during the severe recession of 1981-1982 and topped only in June 1932 (+688bps). In the high yield sector, 29% of credits are trading at distressed levels of 1,000bps over Treasuries, equal to the highest level seen in October 2002 (the bad old days of Enron and Worldcom).

Agency mortgage securities have only begun to benefit from direct government support. Spreads remain attractively above 175bps. Non-agency mortgage bonds, even the senior traunches that enjoy substantial collateral enhancement, remain highly oversold. Considerable uncertainty surrounds the sub-sector's future performance, especially because of the $700B Troubled Asset Release Program. We think price levels have been driven down much further than justified by the fundamentals, due to the imbalance of sellers. We've walked through the scenarios with various bond managers, and find the arguments compelling.

That said, we understand the valuation argument is based on "expert analysis" regarding future default/foreclosure rates and recovery ratios, which sound conservative today but may prove otherwise. If the character of our neighbors has truly and permanently changed for the worse, it stands to reason that most non-agency mortgage paper won't be money good.

But in that event, not much else will be money good either. On balance, we think the non-agency mortgage sector offers double-digit annual return potential over the next 3-5 years, and is the most attractive domestic fixed income opportunity.

Closely following the mortgage-backed securities sector in attractiveness are senior bank loan portfolios. The credits found in this segment mirror those of found in the non-investment grade high yield bond sector, with three important differences:

- Seniority and collateral position is always higher – you are lending closer to the assets;
- Interest rates are floating, usually over LIBOR, which sharply reduces interest rate risk/opportunity. In a rising rate environment, this is a very good thing;
- Bank loans are marketable, but much less so than bonds. This demands more of a buy and hold approach, which places a premium on good security selection in the first place.

Which brings us finally to global bonds. For those boards who recoil at the thought of emphasizing mortgage bonds and bank loans with the little fixed income assets they still have, we think very high quality global bond accounts offer better return/risk prospects than high quality domestic bond accounts. The reasons are –

- Simple diversification of interest rate risk. Many other countries have higher yield curves and real interest rates, because they've been more concerned with fighting inflation than we have.
- Our budget deficits relative to GDP over the next few years will rival those of banana republics. Returns from longer-term domestic Treasury and high-grade corporate bonds will be challenged if this deficit spending causes rates to rise.
- Global bond accounts still may include heavy allocations to domestic bonds, subject to the manager's determination of relative value.
- Diversified currency exposure.

Looking back / looking forward

Since 1994, Chartwell has maintained a model portfolio representing its base, non-client-specific, asset allocation views. This model's objective (which it's achieved) is to exceed the long-term return of a basic domestic balanced portfolio, invested 65% in US large/mid-cap stocks (S&P 500) and 35% in US investment grade bonds (Lehman Aggregate), while at the same time exhibiting lower return volatility.

In turn, our client-specific asset allocation recommendations have been a function of this base model after adjusting (sometimes very significantly) for each client's unique objectives, risk tolerances, and particular circumstances. This report necessarily speaks to the Chartwell base model portfolio, rather than to each client's individual asset allocation issues.

At the end of this report we've set out our model portfolio recommendations as of selected points in time over the past decade, including the changes which took place in June 2007 (when we reduced equity allocations – but not nearly enough) and in July 2008 (when we did more of the same).

The last column of this table also reflects our basic thinking at the beginning of July for those situations that allow the use of Alternative Investment Strategies (real estate, commodities, infrastructure, hedge funds, and private equity investments).

While we've reduced our combined equity targets by 7% from their peak in August 2003, our base model has remained equity-centric to this point, for three reasons: (1) our clients have historically placed a greater value on higher long-term total return versus lower short-term return volatility; (2) we expected equity volatility to increase, but completely underestimated the magnitude and rapidity of the ramp up, and; (3) even at the market's peak one year ago, we saw stocks as fundamentally attractively valued versus bonds.

As alluded to herein, our base model's total stock exposure is being increased to an overweight position of 67% by December 1st, as follows –

- +6% increase to US large/mid stocks, split 4/2 in favor of growth;
- +1% increase in US small-cap stocks;
- -2% decrease in international developed market;
- +2% increase in emerging markets stocks;
- -6% decrease in high quality US bonds;
- -1% decrease in high yield bonds;
- -1% decrease in global bonds
- +1% increase in cash

Chartwell's "Basic 65/35" Global Balanced Asset Mix

Asset Class	Dec-00	Sep-02	Aug-03	Jun-07	Jul-08	with Alternatives Jul-08
STOCKS	***62.0%***	***67.0%***	***67.0%***	***62.0%***	***60.0%***	***42.0%***
U.S. Largecap EQ - Broad						
U.S. Midcap EQ - Broad						
U.S. Smallcap EQ - Broad	0.0%			4.0%	4.0%	2.0%
U.S. Large/Mid EQ - Growth	18.0%	19.0%	14.5%	16.0%	16.0%	10.0%
U.S. Large/Mid EQ - Value	21.0%	22.0%	16.5%	15.0%	15.0%	10.0%
U.S. Smallcap EQ - Value	10.0%	10.0%	10.0%	0.0%		
Int'l Developed EQ - Broad	13.0%	14.5%				
Int'l Developed EQ - Growth			9.0%	10.0%	9.0%	8.0%
Int'l Developed EQ - Value			10.5%	10.5%	9.0%	7.0%
Int'l Emerging Markets EQ		1.5%	6.5%	6.5%	7.0%	5.0%
FIXED INCOME	***38.0%***	***33.0%***	***33.0%***	***38.0%***	***40.0%***	***33.0%***
U.S. Investment Grade Bonds	28.0%	23.0%		22.0%		
U.S. Inv Grd Bonds, 1-10 years			21.0%	0.0%	23.0%	17.0%
U.S. High Yield Bonds	3.0%	4.0%	4.0%	3.0%	4.0%	3.0%
Global Inv Grd Bonds, unhedged	4.0%	4.0%	8.0%	10.0%	10.0%	10.0%
U.S. Treasury Bills, 90-day	3.0%	2.0%	0.0%	3.0%	3.0%	3.0%
ALTERNATIVE INVESTMENTS	***0.0%***	***0.0%***	***0.0%***	***0.0%***	***0.0%***	***25.0%***
Commodities - Broad						3.0%
Fund of Hedge Funds						12.0%
Fund of Private Equity Funds						10.0%
TOTAL	***100.0%***	***100.0%***	***100.0%***	***100.0%***	***100.0%***	***100.0%***