



## Globalization, Correlation Analysis Support Risk Management, Use of Cash in Bear Markets

In our investment decision-making process at Godsey & Gibb Associates, we often refer to a quote attributed to legendary investor Benjamin Graham. It is, “the essence of investment management is the management of risk, not the managing of return.” Given the turbulent financial market backdrop, along with a declining global economic environment, we believe that investors need sound risk management like never before in recent history.

During time periods with rising financial markets and expanding economies, investors usually focus on absolute and relative fundamentals such as price/earnings ratios and price/book values to determine the relative value of one investment over another. But in extraordinary times, a macroeconomic view tends to dominate, with a focus on policy makers like the Federal Reserve and the U.S. Treasury, leading to investor uncertainty.

Since the fall of the Berlin Wall, it is our view that the global economy has become more integrated through increases in foreign trade, foreign investment and the spread of technology. As the correlation analysis below highlights, the five-year period ending December 2007 marked the end of a synchronized global expansion in both economies and financial markets, including an unprecedented rise in the world’s emerging economies. Correlations measure the strength and direction of linear relationships between two random variables. A correlation of 1 indicates an increasing relationship, while a correlation of -1 points to a decreasing relationship. During expansions, investors normally benefit from

broad diversification, indicated by relatively low correlations across asset classes and geographies. However during contractions and bear markets, correlations historically more higher, toward 1, across asset classes and geographies. There are a number of reasons for this, including forced selling by institutional and individual investors to meet liquidity needs, as well a view by many investors that equities as an asset class may need to be temporarily underweighted or avoided altogether.

We have witnessed these phenomena over the course of many economic and market cycles, including Black Money in October 1987, the “Asian Contagion” and Long-Term Capital Management crisis in the late 1990s, and the bear market in 2000 – 2002. The correlation matrix below supports this concept over the year-to-date period of 2008 as well. Of the 42 correlation combinations, 28 (67%) increased year-to-date relative to the five-year expansion period that ended in December 2007. Correlations for 14 (33%) combinations decreased. Of these 14, 10 (71%) included cash. (Green indicates up, red shows down).

In summary, risk management drives out investment decision-making process. Therefore, we have made several changes over the course of the last 15 months, including moving to a zero weight in small cap and emerging market equities, and an increase in cash positions for preservation of capital and flexibility. We continue to believe that while economic and market cycles are realities, relationships change, making a prudent, dynamic investment process all the more important in a risk-driven environment.

**Correlation Matrix 12/2002 - 12/2007**

Description		1	2	3	4	5	6	7
Standard & Poor's 500	1	1.00	0.88	0.84	0.82	0.68	-0.10	-0.06
Standard & Poor's 400 Mid Cap	2	0.88	1.00	0.96	0.75	0.68	-0.16	-0.13
Standard & Poor's 600 Small Cap	3	0.84	0.96	1.00	0.72	0.66	-0.24	-0.16
MSCI EAFE	4	0.82	0.75	0.72	1.00	0.82	-0.02	-0.06
MSCI Emerging Markets	5	0.68	0.68	0.66	0.82	1.00	-0.03	0.01
Lehman Bros Int Govt/Credit Bond	6	-0.10	-0.16	-0.24	-0.02	-0.03	1.00	0.08
Citigroup Treasury Bill 3 Month	7	-0.06	-0.13	-0.16	-0.06	0.01	0.08	1.00

Source: Informa PSN

**Correlation Matrix 12/2007 - 9/20/08**

Description		1	2	3	4	5	6	7
Standard & Poor's 500	1	1.00	0.96	0.96	0.86	0.71	-0.01	-0.21
Standard & Poor's 400 Mid Cap	2	0.96	1.00	0.91	0.91	0.80	-0.02	-0.25
Standard & Poor's 600 Small Cap	3	0.96	0.91	1.00	0.74	0.58	-0.04	-0.30
MSCI EAFE	4	0.86	0.91	0.74	1.00	0.95	0.07	-0.11
MSCI Emerging Markets	5	0.71	0.80	0.58	0.95	1.00	0.04	-0.09
Lehman Bros Int Govt/Credit Bond	6	-0.01	-0.02	-0.04	0.07	0.04	1.00	0.75
Citigroup Treasury Bill 3 Month	7	-0.21	-0.25	-0.30	-0.11	-0.09	0.75	1.00

Source: Informa PSN

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