



December 31, 2010

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Joe Battipaglia
Chief Investment Officer

Kevin Caron
Portfolio Manager
973-549-4051

Chad Morganlander
Portfolio Manager
973-549-4052

Tactical Allocation: First Quarter 2011

The Federal government, in conjunction with the central bank, appears to have been successful in heading off a severe deflation in the United States, and the private sector appears more confident. Financial markets appear convinced that the system is either fundamentally sound, or too big to fail. Either way, better stock market performance since the summer, combined with tighter credit spreads, higher gold and metals prices, a higher rate of inflation priced into the bond market, and a steeper yield curve all augur well for risk-taking. Entities facing default a few quarters ago have been extended a life line as many risks were backstopped by the government, and investors were willing to move further out along the risk spectrum by extending credit to these entities. Companies, and even countries such as Ireland, have refinanced and extended the maturity of debt, which means that default rates, losses, forced liquidations, and deflation must wait.

Governments played an enormous role in engineering this outcome. Only two years ago, as the financial crisis was unfolding, the U.S. government put in place over \$10 trillion of loans, backstops, guarantees, emergency stimulus, and equity investments to rescue a system on the brink of collapse. Similar measures were enacted overseas. Since then, several of those measures have run off, but policy is still operating on an "emergency footing."

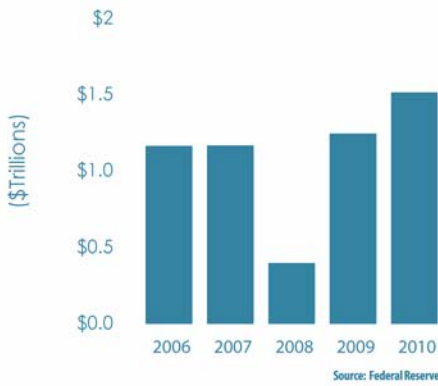
Government assistance should decline next year because emergency measures are seen as inappropriate in an economy that is expanding, because inflation is picking up in some countries, because Europe's debt problems are forcing fiscal changes, and because the theme of deficit reduction is resonating with the electorate here in the United States. Therefore, we expect the government contribution to growth to decline next year.

Fortunately, the counterweight to government deficits is business investment. Here, we see some positive trends. Business investment is improving up 20% since last year. At this rate, the economy should see \$200-300 billion of autonomous investment, which carries with it a relatively high multiplier effect. This means that such investment ultimately produces an effect on the economy far greater than the initial investment. Hence the heartbeat of the private economy seems to be gathering strength just as government spending is fading.

Real and significant pain and suffering is still apparent for many in the economy today. However, better data in the private sector, coupled with a market that is willing to take on risk, is an unqualified positive development.

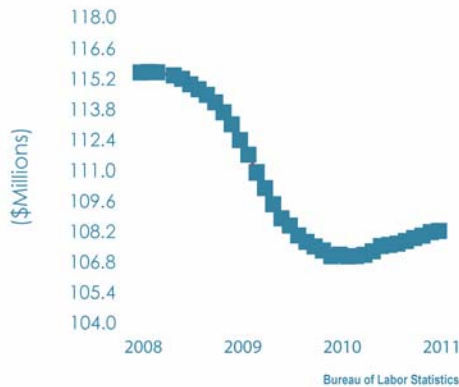
Business Investment

Non-Financial U.S. Business



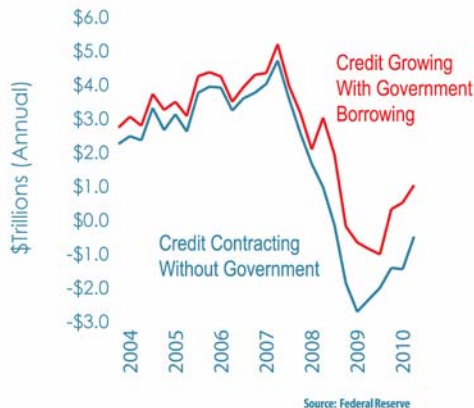
Private Sector Payrolls

Growing Slowly



Credit Creation

Net New Borrowing Led by Gov't



2011 Outlook

A couple of years ago, businesses slashed headcount and investment at a breakneck pace. The private sector shed almost 9 million jobs in just over a year and a half, and investment spending fell by \$400 billion, or 20%. Business was responding to a darkening outlook for the economy, and a drying up of financing. As these cuts were being made, profits were evaporating as companies watched profits drop by half to \$640 billion from \$1.3 trillion. Fortunately these trends seem to be reversing at this time.

Throughout 2008-2010, the Federal Government stepped into this void and has been running deficits well over a trillion to fill in the spending gap left by the private sector. The combination of government spending, lean corporate budgets, and record low cost of available capital sent profits back to pre-crisis levels. With profits re-energized, the hope now is that private businesses will be capable of carrying the water from here.

The ideal scenario would be that corporations accelerate investment (top chart) and hiring (middle chart) while private sector credit creation gains momentum (bottom chart). These trends would go a long way to allowing for a sustainable expansion.

A second scenario is that corporations could again begin to anticipate weaker demand as the impulse from government spending wanes, and instead of expanding risk-taking into investment and hiring, fall back on the miserly behavior that allowed them to restore profitability. Cash, instead of being reinvested with a multiplier effect in the economy, could be used to build a buffer against uncertainty, used to buy back shares, or simply paid out to shareholders. This would result in a lower growth rate, higher unemployment, and lower equity valuations. Fortunately, however, our data suggests that we are not on this path at the moment.

The path we go down in 2011 will largely be dictated by confidence. Confidence on the part of households to borrow and spend; confidence on the part of bankers and investors to extend credit; and confidence of large and small business owners to make investments. This is why the state of speculation is especially important at this juncture in the road. This is also why policies that foster risk-taking, such as extraordinarily low interest rates and low tax rates on capital, are likely to remain until such a time that private sector expansion becomes self-reinforcing.

It seems to us that we are a long way from that condition. We see record profit margins as a percent of GDP as unsustainable in the long-run (because higher costs must be incurred in a profit-maximizing, growing economy). We see zero percent interest rates, contracting private credit, and direct asset purchases by the central bank as not consistent with a normalized environment. We view budget deficits as high as 10% of GDP as inconsistent with sustainable growth. All of these things are necessary evils in the "pump-priming" stage, but things that we would expect to reverse once the economy returns to self-sustaining expansion.

With the WCA Composite Conditions Index™ presently above 50, we place higher odds of occurrence on the recovery scenario.

Our analysis of credit and capital market conditions, economic data in the United States, and foreign trade and production leads us to conclude that the economy is on a recovery path.

Accordingly, we see modest growth in overall output with potential upside surprises coming from areas tied to business investment and trade. Following on from this investment, we would expect to see further increases in private sector payrolls, a lower unemployment rate, and increased unit sales of automobiles along with retail sales. Confidence surveys should move back toward more normal levels (from today's historically depressed levels), and housing should continue to stabilize. Overall gross domestic product should grow at a 2-3% annualized pace, and underlying inflation should remain in the 2-3% range as public sector credit expansion and private sector credit contraction cancel each other out.

Should the recovery continue, and our indicators remain at current positive levels, the S&P 500 should generate earnings of \$80-90. Our "fair value" range for the S&P 500 under these assumptions is 1,120 (14 times \$80 in earnings) to 1,440 (16 times \$90 in earnings). This implies a range of returns of -10% to +17%, including a 2% dividend yield. Based on our reading of 70 for our WCA Composite Conditions Index™, our currently estimated expected return for the S&P 500 is 9% ($70\% * 17\% + 30\% * -10\%$).

10-year Treasury bonds are expected to yield 3-5%, with underlying inflation of 2%. Real yields, adjusted for inflation would, therefore, range from 1-3% — well within the range seen since 2000, but below the range experienced during the 1990s of 3-5%. With 10-year Treasury yields currently at 3.4%, we could envision a reasonable range of expected returns of -9% (should yields rise to 5%), and 5.7% (should yields fall to 3% over the next 12 months). With our diffusion index currently at 70, the estimated expected return for Treasuries bond is near -5% ($30\% * 5.7\% + 70\% * -10\%$).

Hence, the positive differential between stocks (expected return of 9%) and bonds (expected return of -5%) favors stocks at this time.

Of course, there are always risks to any forecast. In addition to surprise factors, we are currently watching three areas that could negatively impact the recovery scenario. These include:

China – The country continues to grow rapidly, but is attempting to slow growth to quell inflation. A "hard landing" that bursts their property bubble would have negative implications for growth.

Housing – Data on housing in the U.S. is mixed, at best. After an \$8,000 tax credit helped lift sales and prices in early 2010, most areas are again seeing year-over-year declines in home prices, and foreclosure rates remain high.

Sovereign Credit Risk – We see that the risk of default by one or more foreign governments remains elevated despite efforts by the European Union to stem the crisis.

Fading Stimulus – With data pointing toward improvement, and with heightened concern over deficits, the rate of stimulus growth should be curtailed.

Our analysis of credit and capital market conditions, economic data in the United States, and foreign trade and production leads us to conclude that the economy is on a recovery trajectory.

We are currently watching four areas that could negatively impact the recovery scenario...

China...

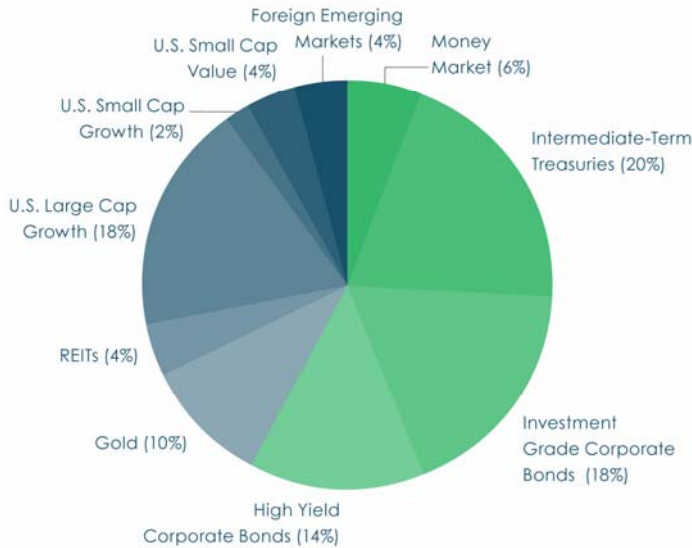
Housing...

Sovereign Credit Risk...

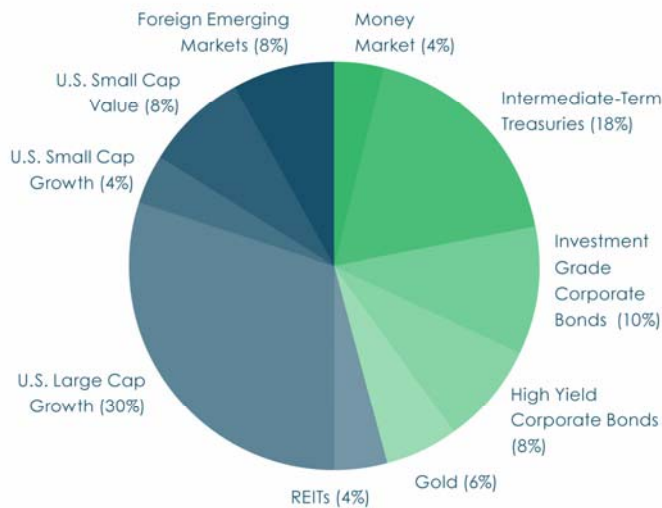
Fading Government Stimulus...

Model Portfolios

Conservative Portfolio Allocation
Equity Policy Range: 0-50%
Current Equity Exposure: 32%
December 31, 2010



Balanced Portfolio Allocation
Equity Policy Range: 25-75%
Current Equity Exposure: 54%
December 31, 2010



Equity ■
Non-Equity ■

Conservative

The target range of common equity exposure for the portfolio is **0-50%**. The portfolio offers a more conservative mix of assets emphasizing bonds over equities. Investors with a relatively short to medium time horizon and lower risk tolerance who desire some modest growth may prefer this profile...

Balanced

The target range of common equity exposure for the portfolio is **25-75%**. The portfolio provides a mix of equity and fixed income investments. It is most appropriate for investors with a long to medium investment time horizon and moderate risk tolerance...

Growth

The target range of common equity exposure for the portfolio is **50-100%**.

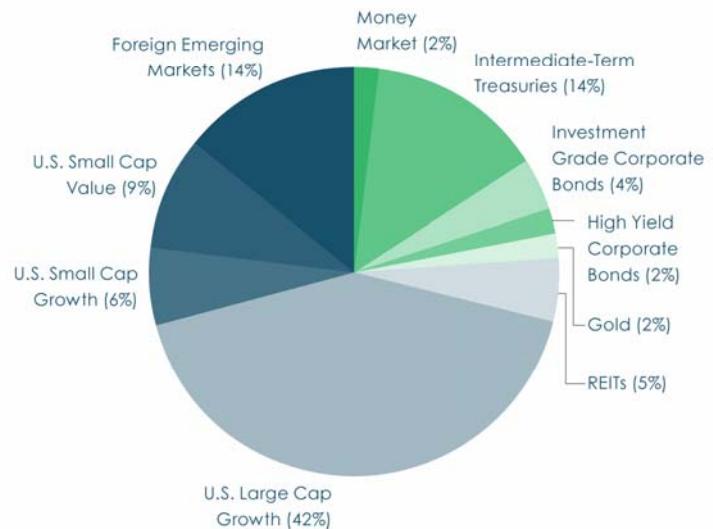
The portfolio invests primarily in equity funds. It is appropriate for investors with a longer time horizon and a high tolerance for risk...

Aggressive

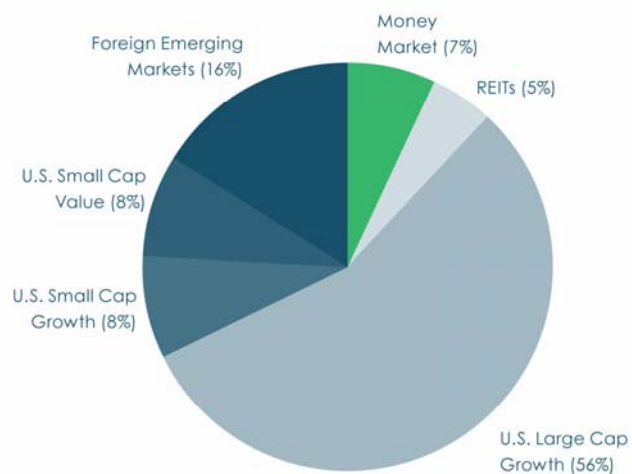
The target range of common equity exposure for the aggressive portfolio is **75-100%**. This portfolio is for investors with a long time horizon and high tolerance for risk. This portfolio may be an effective complement to an existing bond portfolio...

Model Portfolios

Growth Portfolio Allocation
Equity Policy Range: 50-100%
Current Equity Exposure: 76%
December 31, 2010



Aggressive Portfolio Allocation
Equity Policy Range: 75-100%
Current Equity Exposure: 93%
December 31, 2010



Equity ■
Non-Equity ■

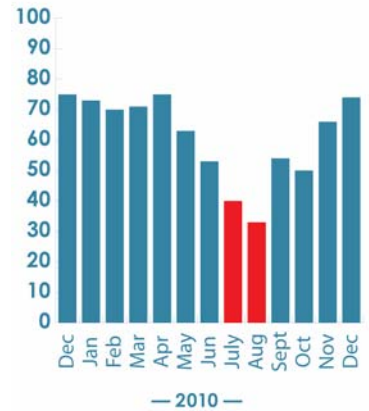
Update on Fundamental Conditions

We update our investors quarterly about the status of our various indicators. These are “diffusion-style” indices designed to identify what percentage of the indicators under examination are rising or falling. The credit, U.S. economic, and foreign indices each summarize the performance of ten indicators that we view as especially relevant to investors in each category. The composite index is the average of credit, the U.S. economic, and foreign indices. Readings above 50 generally indicate expansion (which tends to favor higher risk and equity exposure), while readings below 50 generally indicate contraction (which tends to favor bonds and lower risk exposure).

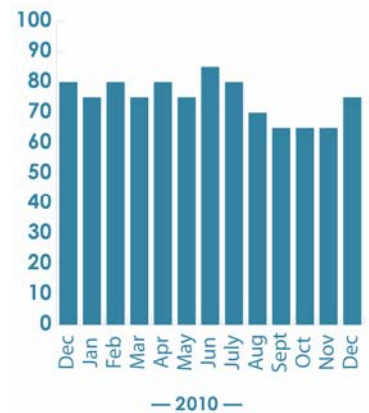
- ◇ WCA Credit and Capital Market Conditions Index™ rose to 74
- ◇ WCA U.S. Economic Conditions Index™ rose to 75
- ◇ WCA Foreign Conditions Index™ rose to 55
- =====
- ◇ WCA Composite Index™ rose to 68

Given the level and trend in our WCA Composite Index™, we have adopted a more aggressive portfolio posture. Improvement is evident across a wide range of different types of data and has persisted for a few months.

WCA Credit Conditions Index™

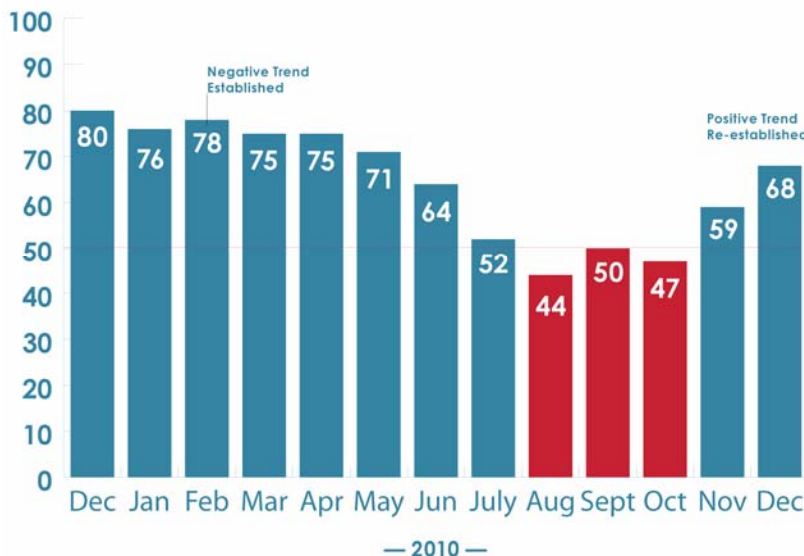


WCA U.S. Economic Conditions Index™

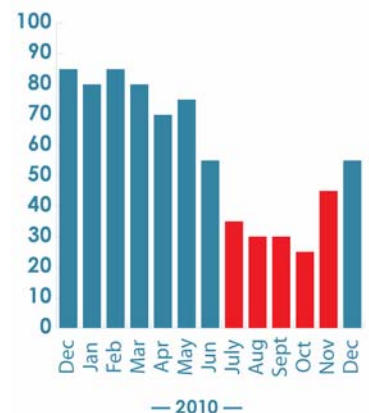


WCA Composite Conditions Index™

Last 12-month readings



WCA Foreign Conditions Index™



Description of Trend Measurement

Trends measured using relative price observations measured at 8-week, 26-week, and 62-week moving averages.

Tactical trends are always viewed in terms of relative performance. In other words, the performance of one asset class is measured against the performance of another, rather than measuring each in absolute terms.

Time Horizon for Evaluating Trends

We measure macro trends over weeks and months, rather than days. We believe that this perspective is appropriate for capturing dominant market trends over time.

Valuation Check

These observations serve as rough guides to identify when anomalies in valuations occur. It is at these extremes when contrarian actions should be considered. Such actions are generally contrary to the prevailing trend.

Update on Valuations

After underperforming bonds by over 20% from last April through August, stocks are once again outperforming bonds. Long-term bond yields have moved back up to 3.4% from 2.4% since August, despite the Fed's Treasury purchase program. Gold, along with the Commodity Research Bureau's commodity index, remains in a bull market.

There remains no clear leadership between foreign or domestic equities. The dollar index, similarly, remains without a trend as investors weigh whether dollars or Euros are the "least bad" currency. Growth appears to be outperforming value, and small capitalization stocks appear to be performing better than large.

As for bonds, shorter maturities are performing better than longer maturities, and credit instruments are performing better than sovereign. Inflation-protected bonds are performing better than non-inflation-protected bonds as rising inflation expectations are put back into the market. These trends are consistent with what we see in our WCA Composite Conditions Index™, which has moved back up above 50 (indicating positive risk appetites and an improving economy), and as the trend is now positive.

Valuation Check:

- ❖ Bonds
 - 30-Year Treasury Yield vs. Inflation
 - The 30-Year Treasury bond yields 4.3%. The consumer price index has risen 1.1% year-over-year. Thus, the Treasury's return above the inflation rate is 3.2%. That rate is in the middle of the 20-year range for this measure of 1-5%.
 - Corporate Yields vs. Treasuries
 - The Moody's Baa-rated corporate bond index yields about 6.1%. This yield is 1.8% above the 30-year Treasury. That rate is in the middle of the 20-year range for this measure of 0.7-2.9%.
- ❖ Stocks
 - The S&P 500 earnings yield vs. Inflation-Adjusted 30-Year Treasury Yield (Equity Risk Premium)
 - The earnings yield (inverse P/E) for the S&P 500 is 6.3%, based on trailing earnings. By comparison, the real yield on a 30-year Treasury is 3.2%. The 3.1% incremental yield for owning large cap stocks is slightly above the midpoint of the 20-year historic range of 0% to 5%.

Relative valuations incorporating prices for stocks and bonds, along with observations on earnings and inflation, lead us to conclude that the major asset classes are within a reasonable range of equilibrium from strictly a valuation perspective.

Sector Allocations

	Portfolio Weight	S&P 500 Weight	Relative Weight
Energy	10%	12%	-2%
Technology	13%	19%	-6%
Materials	10%	4%	6%
Industrials	13%	11%	2%
Consumer Discretionary	17%	11%	6%
Cyclical Sectors	63%	57%	6%
Health Care	10%	11%	-1%
Utilities	13%	3%	10%
Consumer Staples	0%	11%	-11%
Telecommunications	13%	3%	10%
Financials	0%	16%	-16%
Non-Cyclical Sectors	37%	43%	-6%
Total	100.0%	100.0%	0.0%

Moved allocation toward cyclical from non-cyclical. Biggest shift has been to energy and materials. Solid growth in emerging markets, better tone in the United States as reflected in the data (see page 6), and firming commodity prices support this shift, in our view.

Sector Fundamentals

	Earnings Multiple	Earnings Growth	P/E to Growth
Energy	12.7	23%	0.5
Technology	13.7	21%	0.7
Materials	14.6	36%	0.4
Industrials	14.9	18%	0.8
Consumer Discretionary	14.8	19%	0.8
Average Cyclical Sectors	14.1	23%	0.6
Health Care	11.2	11%	1.1
Utilities	12.6	0%	N.A.
Consumer Staples	14.2	10%	1.4
Telecommunications	16.2	11%	1.5
Financials	12.3	33%	0.4
Average Non-Cyclical Sectors	13.3	13%	1.0
S&P 500	13.3	19%	0.7

Portfolio Changes: Third Quarter 2010

December 2010 Tilted sector exposure to overweight cyclical sectors (add: Energy / Materials; subtract: Staples)

December 2010 Increased equity exposure via Emerging Markets on rise in WCA Composite Conditions Index™

Watch List

China

China's efforts to jumpstart its economy out of the 2007-2008 doldrums was a catalyst for resurgence in global manufacturing. Strong money supply growth was also a factor that ignited growth. While still expanding, efforts to tamp down money growth and inflation could create headwinds if not orchestrated properly.

Housing Recovery

A small improvement in housing sales and values in late 2009 and early 2010 was likely aided by a one-time tax credit. More recently, we have seen a return to price and demand erosion now that the credit has been removed.

Government Budgets and Spending / Sovereign Credit Risks

Western governments have spent heavily in the early stage of economic recovery. Much of the initial impetus to growth resulted from these efforts. However, concerns about unsustainable debts and deficits are becoming a concern. As government spending fades, it is unclear exactly what the impact (if any) will be on growth, unemployment, interest rates, and profits.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NAREIT. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.