Tactical Allocation: Q1 2012

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Highlights:

Months of slippage in fundamental data have left investors concerned about the outlook. Although Europe's troubles grabbed the headlines, the process of household balance sheet repair continued in 2011 and remains the single most important thematic as we head into the new year.

- ✓ *Balance Sheet Repair Advanced in 2011:* Reduced debts and rising income puts household balance sheets in a better position. Despite the slow economy, debts are on the decline as income continues to rise.
- ✓ *Higher Savings Rates Provide Cushion / Catalyst:* Today's higher savings rate may mean less spending now but a larger pool of investment capital to drive growth down the line.
- ✓ *Fundamental Conditions Set to Improve:* We now anticipate an improvement in conditions in the first half of 2012 and expect the U.S. to avert double-dip recession.

Asset Allocation Summary

Asset Class	Current Outlook	Tactical Posture
Allocation	Fundamentals not yet turned positive, but should soon	Bonds over Stocks
Equities		
Global	Foreign fundamentals / manufacturing still weak	U.S. over Foreign
Stage of Development	Weak commodity markets / stronger dollar favor developed	Developed over Emerging
Market cap	Weak global fundamentals tend to favor larger cap	Large over Small
Style	Growth bias based on earnings dynamic and lower leverage factor	Growth over Value
Fixed Income		
Quality	Spreads somewhat better, but continue to focus on quality	High Grade over High Yield
Region	No QEIII and stronger dollar favors United States	Domestic vs. Foreign
Duration	Rally in long-end of curve leaves real long-term yields less attractive	
Commodities & Other		
Commodities	Stronger dollar keeps lid on commodities, for now	Neutral
REITS	Decent yield spread over Treasuries	Neutral

The U.S. Economy in 2012

We expect the U.S. economy to grow about 2% in 2012, slightly faster than 2011's 1.5-2.0% growth rate.

As we noted in our last commentary, consumers have spent the last couple of years increasing savings to replace lost wealth in the recession. Some of these saved dollars should find their way into the economy this year. Some additional refinancing activity, due to record low mortgage rates, may also provide some incremental boost to domestic spending. With the average age of an automobile now over 11 years, even automobile sales may see a lift as clunkers head for the scrap heap.

There are also some indications that private sector job creation is looking up, and businesses are using expiring tax incentives to invest in new equipment and expanded production. Fears of a severe financial crisis have been put on hold with stepped up intervention by the European Central Bank and further austerity measures. However, we probably have not seen the end of Europe's troubles, as large parts of Europe have already slipped back into recession. U.S. exports to Europe may well get trimmed, which could put a drag on GDP by about 0.25-0.50% this year. Finally, housing may actually contribute a small positive to growth this year after being a headwind to growth in recent years.

None of this changes the fact that this is the slowest recovery on record since the Great Depression. Private sector jobs are still about 5 million below the peak and 10 million below trend. The harsh truth is that there are the same number of private sector workers today as there was in 1999, despite a population which is 12% larger. A 2% growth rate is simply not fast enough to absorb new entrants to the workforce and makes for a very slow recovery. Therefore, we conclude that a self-sustaining recovery has not yet taken root, although the official numbers are expected to show more jobs and more GDP. A good outcome would be for continued, but slow progress.

With such slow growth, an external shock could tip the U.S. into another recession. In this "risk case," the Treasury and the Fed would have less latitude to act to boost growth, since deficits are already high and interest rates are already low.

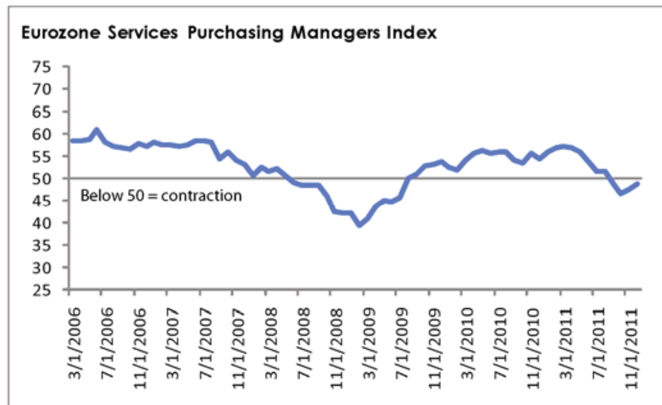
To prevent such an interruption to growth, the payroll tax credit will likely be extended, but we expect no new stimulus. There is little discussion of a new round of stimulus from Republican candidates on the hustings or from the oval office. The debate over the debt ceiling was one of the low points of 2011, and there is no Presidential candidate who wants to appear soft on the deficit. Even the Federal Reserve, which had been previously vocal about things like quantitative easing, has become more gradualist in its approach to monetary policy, and the Fed's board of governors has become increasingly divided on monetary policy.

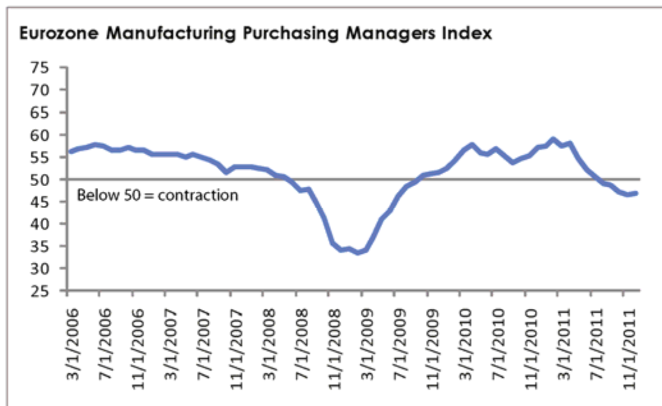
Europe's Troubles Continue

Europe appears headed for a further slowdown in 2012. Austerity measures across the continent could shave an additional 1-2% growth off of an already weak economy. Several measures of economic activity indicate recession-like growth across much of the region, and money supply growth remains slack.

Europe's key challenge is how to produce growth from private initiative. Governments continue to struggle to pursue the kinds of big-spending initiatives that were relied upon to stoke demand in the years immediately following the latest recession, but the electorate and markets have grown leery of deficits. The unemployment rate for the Eurozone is back above 10%, and Greece, Italy, Spain, Ireland, and the United Kingdom are all in or near recession. Purchasing managers indices for both services and manufacturing in the Eurozone are both in contraction for each of the past four months (see below). We expect the recession to proceed into 2012, but remain fairly modest in relation to the past recession.

For these reasons, we prefer limiting exposure to European equities (for now), favoring, instead, larger-cap domestic companies.





The "New" Fed

Medium and long-term interest rates are near record lows due to global concerns over Europe's debt crisis and efforts by the Federal Reserve to lower long-term rates through direct purchases of longer-term bonds.

Last summer, we saw the 10-year Treasury note fall below 2% despite market-based forecasts of long-run inflation greater than 2%. The fear and concern brought about by last summer's downgrade of U.S. Treasury obligations by Standard & Poor's, coupled with renewed concerns about Europe's banks, drove investors to find a safe harbor. Somewhat ironically, that safe harbor was the U.S. Treasury, despite S&P's rebuke. Assuming fundamentals improve, we would expect the medium-term rates to rise to between 2.5% and 3% by the end of 2012.

As for the Fed, we expect the central bank to remain focused on overall credit expansion in the United States. Currently, overall credit is expanding at a very modest pace, despite large increases in government borrowings in recent years. We have seen very little appetite for new borrowings by households, who continue to be hesitant to take on new obligations and appear more interested in paying down debt, despite record low interest rates. This lack of new demand for credit has a depressing effect on overall inflation and will keep the Fed on watch for deflation. To offset this, the Fed will continue to seek ways of injecting new liquidity into the economy. Up until recent times, the Fed set rates for overnight loans between banks as the primary lever for influencing long-term rates, but those rates have been near zero since 2008. Since then, the Fed has relied more on other measures, such as bond purchases, to drive monetary policy.

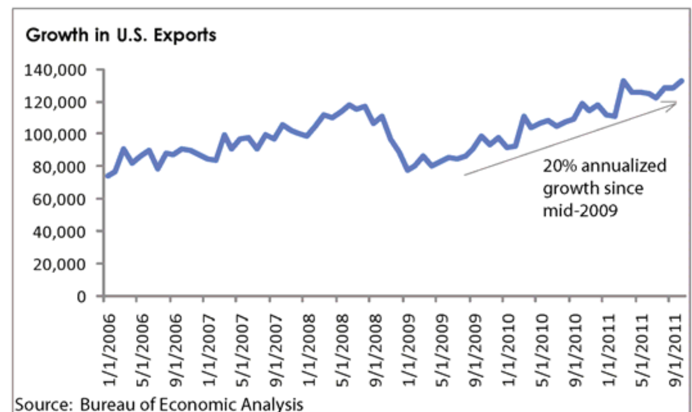
2011 was another year of unconventional measures. Last year's "operation twist" involved the Fed buying longer-term bonds with proceeds from shorter-term holdings on their balance sheet, effectively lengthening the duration of the Fed's balance sheet and reducing longer-term interest rates throughout the economy. The Fed also announced in 2011 its intention to keep short-term rates near 0% through mid-2013 in another unconventional move. Recently, the Fed also introduced the possibility of announcing future targets for the size of their balance sheet ($2.9 trillion currently) and, hence, additional purchases. This new communication strategy conceivably paves the way for additional, open-ended asset purchases should the Fed deem such purchases necessary. The pace of recovery in the months ahead will dictate whether, and to what extent, this new communications tool is used.

We will continue to watch market-based indicators and the Fed's own estimates for economic growth and inflation. We expect the Federal Open Market Committee to announce a numerical target for interest rates and details on "trigger levels" for inflation and unemployment that would require a policy change. This new style of communication is a major change in the way monetary policy has been implemented in the United States. Just a few years ago, it was thought that effective monetary policy should be shrouded in mystery. We expect to get another peek inside the Fed's thinking when new quarterly projections are released at the FOMC's next meeting toward the end of January. How times have changed!

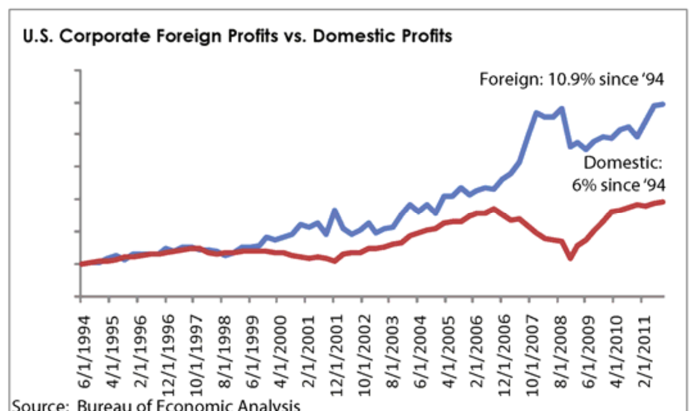
Trade as Engine of Growth

Trade has been a bright spot during this recovery. Specifically, the total dollar value of exports out of the United States since the start of the recovery has increased at an annualized rate of over 20% (see chart). We expect export-led trade to expand again in 2012, but the pace of growth should slow in the first half of the year given a recessionary tone in Europe and more modest growth expected in Asia.

Although trade continues to be the primary engine for global growth, we recognize that recent data has been soft. Emerging market economies possess strong longer-term fundamentals (improved economic fundamentals, better balance of payments, expanding demographics, and greater policy flexibility), but are subject to greater downside volatility when fundamentals are poor. Accordingly, we have trimmed our exposure to emerging markets on a tactical basis, awaiting signs of improved fundamentals.



Source: Bureau of Economic Analysis



Source: Bureau of Economic Analysis

Ten Themes for 2012

We see 2012 as getting off to a slow start, but with the potential for better returns as the year progresses. Looking out from here, we see several thematics that will continue to be with us throughout our forecast horizon.

1) Private sector balance sheet repair continues. This brings longer-term benefits at the expense of growth near term;
2) Inflation rates remain low and tend toward disinflation or deflation. Excess capacity in labor markets, coupled with lack of private sector credit growth, are the primary reasons behind soft prices;
3) Growth is expected to outperform value given better earnings dynamic and higher share of revenues sourced from more rapidly rising trade;
4) Europe is expected to find a resolution to debt crisis, but not before additional political posturing and compromise;
5) Financials continue to struggle with the inability to find margin and volumes in the face of ongoing private sector deleveraging;
6) Bond yields remain low in 2012, but begin to normalize as the year progresses, and markets begin to anticipate some normalization of monetary policy beyond 2013;
7) Dollar remains relatively weak on a trade-weighted basis and contributes to growth in exports and earnings through 2012;
8) Commodities, including gold, continue to provide a hedge against policies designed to inflate global currencies;
9) Lagged effects of monetary easing begin to exhibit themselves toward the second half of the year, but growth remains sub-par;
10) Dividend yields rise as companies have the room to increase dividends and remain concerned about sizable commitments to new investment in light of continued economic uncertainty.

Portfolio Posture

Portfolios are allocated within their strategic ranges to maintain diversification. Exposure to higher volatility equities has been reduced in favor of bonds as markets incorporate nine months of deteriorating fundamentals into prices.

We are awaiting some improvement in fundamental data before returning portfolios to a closer alignment with the midpoint of longer-term strategic asset allocation ranges. So far, we have yet to see sufficient evidence of improvement to take that step (particularly in credit markets and foreign indicators). We are, however, sensitive to the fact that domestic economic trends have shown some measurable signs of improvement. Should these trends broaden out in the weeks and months ahead, it would follow that portfolio exposure to equities should be increased.

For now, portfolio equity exposure versus their "neutral" stock and bond allocations are as follows:

Aggressive Growth	82% Equity vs. 90% "Neutral" Target
Moderate Growth	61% Equity vs. 75% "Neutral" Target
Balanced	39% Equity vs. 50% "Neutral" Target
Conservative	27% Equity vs. 25% "Neutral" Target

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A Barometer for Assessing Changing Conditions

We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions.

Analysis incorporates approximately 30 forward-looking indicators in categories ranging from **Credit and Capital Markets** to **U.S. Economic Conditions** to **Foreign Conditions.**

From each category of data, we create 3 diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks); while readings below 50 would indicate potential deterioration (potentially favoring bonds).

The WCA Fundamental Conditions Index™ combines the 3 underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

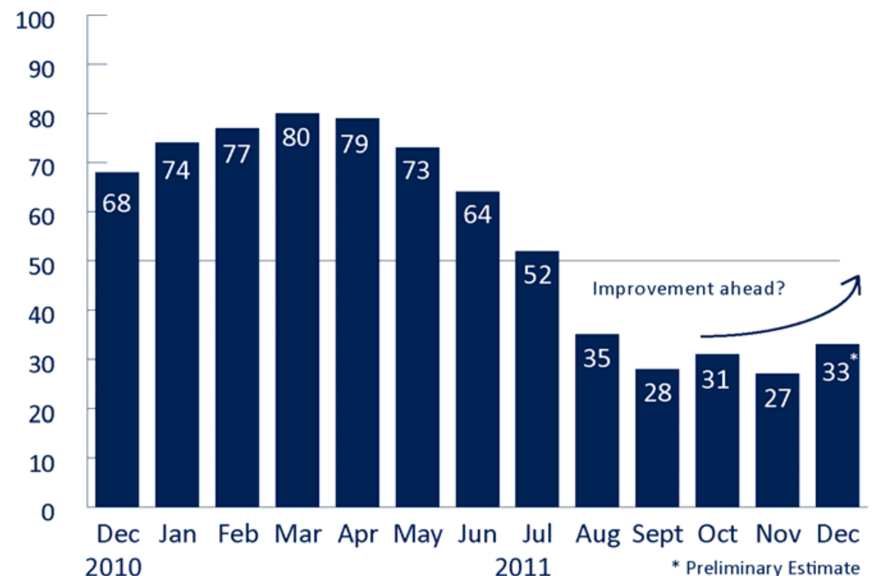
Update on Fundamental Conditions

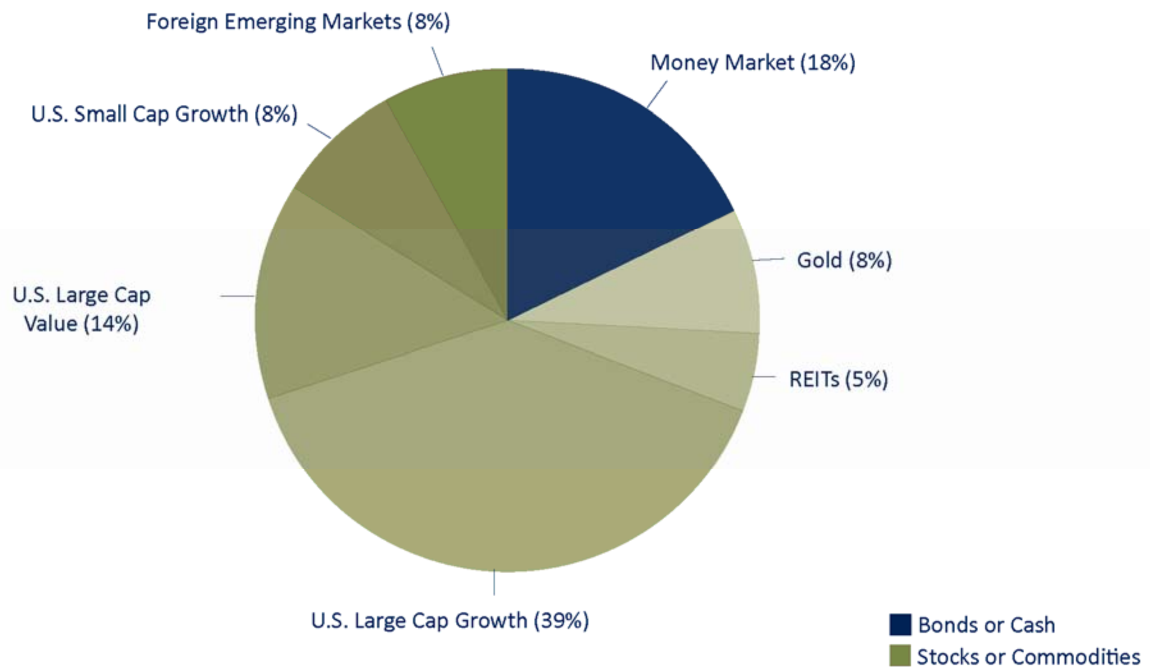
The fundamental backdrop is mixed, but an improvement in domestic trends coming into the new year is a bright spot. Credit conditions and foreign indicators remain weak, given concerns about Europe and a slowdown in China. The following is a quantitative assessment of 30 indicators measuring the strength of trends within credit and capital markets, the domestic economy, and foreign markets.

WCA Indices*

>50 Favors Stocks / <50 Favors Bonds

	Last	Current	Change	Summary
Credit & Capital Markets	25	20	-	Falling, Slower rate
U.S. Economic Conditions	35	60	-	Rising, Faster rate
Foreign Conditions	25	20	-	Falling, Slower rate
Fundamental Conditions	28	33	-	Level, Steady



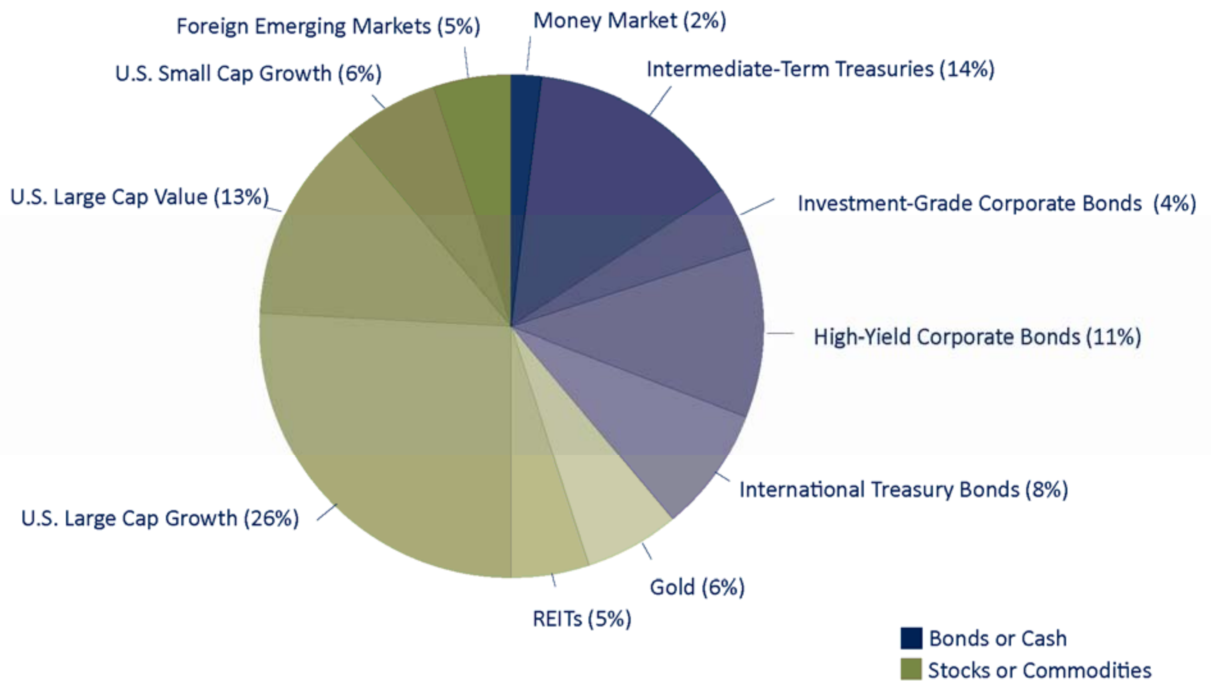


Investment Posture

The AGGRESSIVE PORTFOLIO invests between 80-100% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 90% stocks and 10% bonds. Because of the high degree of exposure to stocks, investors in this portfolio should have an investing time horizon of at least 20 years or be able to accept greater variability of returns associated with stock market investing.

- In the last quarter, downward movement in the WCA Fundamental Conditions Index™ (see page 5) continued. The portfolio exposure to equities remains slightly below the "neutral" 90% allocation in light of weaker fundamental conditions.
- Largest concentration at the end of the quarter was domestic large cap growth given exposure to fundamentally attractive sectors and better earnings growth dynamic relative to value.

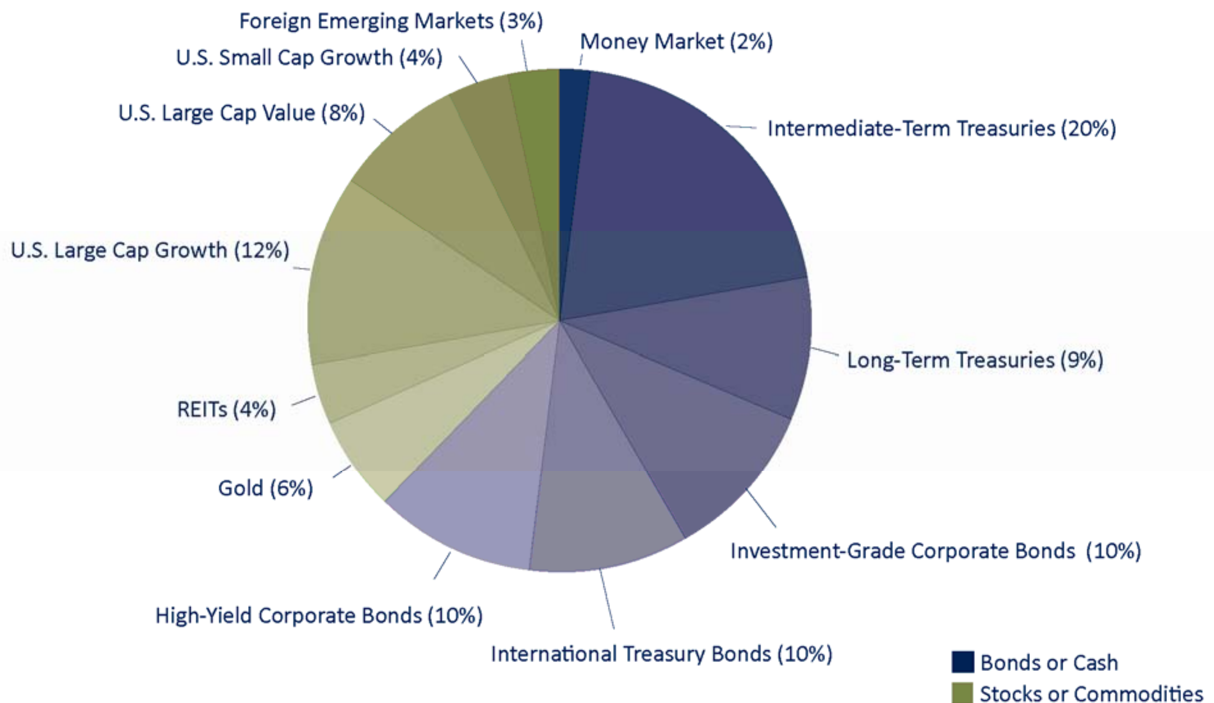
Moderate Growth Portfolio Allocation
Equity Policy Range: 50-100%
Current Equity Exposure: 61%
December 31, 2011



Investment Posture

The MODERATE GROWTH portfolio invests between 50-100% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 75% stocks and 25% bonds. Because the portfolio invests primarily in stocks, and secondarily in bonds, the portfolio may be appropriate for investors with a time horizon of at least 15 years or those who seek principal growth with a moderate amount of income.

- In the last quarter, emerging markets and small cap exposure was trimmed given the downward movement in the WCA Fundamental Conditions Index™ (see page 5). Proceeds were reallocated toward intermediate-term Treasuries.
- High-yield corporate bonds and REITs provide a flow of income into the portfolio at rates above that provided by Treasuries.
- Equity holdings are tilted toward domestic large-capitalization growth which are least correlated with Europe's sovereign debt and banking issues.



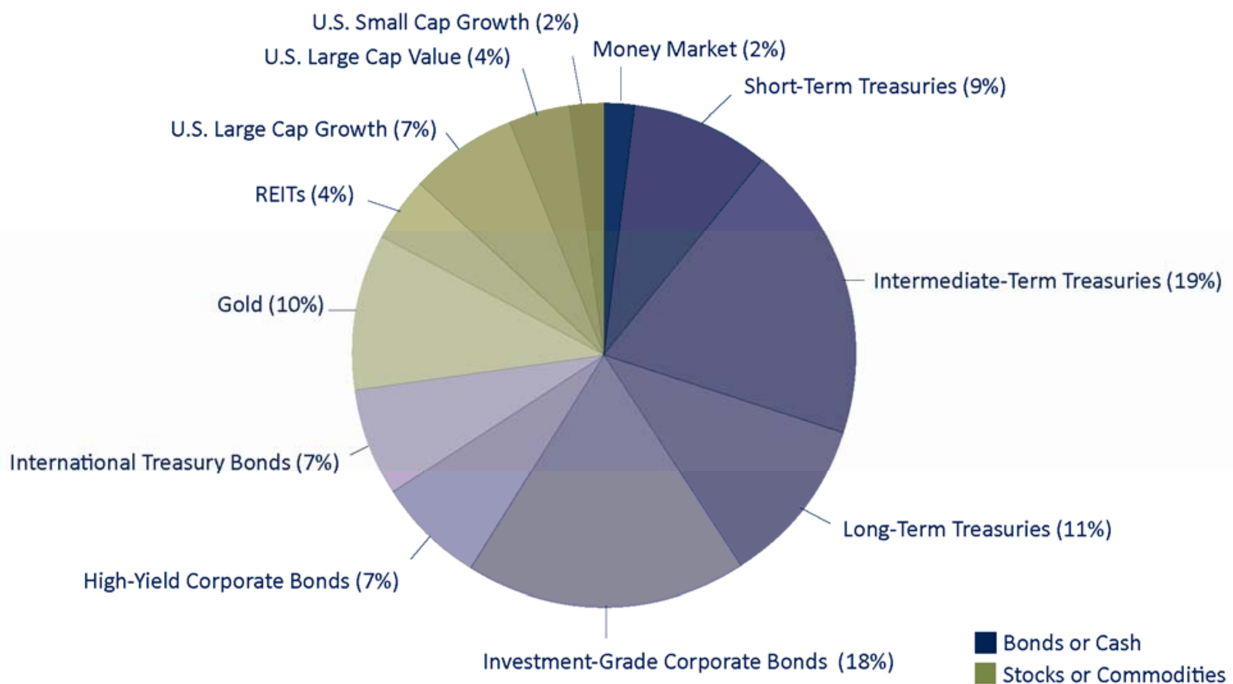
Investment Posture

The BALANCED PORTFOLIO invests between 25-75% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 50% stocks and 50% bonds. The portfolio provides a mix of stocks and bonds without a bias toward either. It may be appropriate for investors with a time horizon of at least 10 years with a moderate risk tolerance.

- This portfolio is broadly diversified across stock and bond markets. Exposure to non-dollar denominated assets is included alongside dollar denominated stocks, bonds, REITs, and gold. The portfolio is currently allocated below its “neutral” position for stocks and bonds in keeping with fundamental conditions.

- In the last quarter, emerging markets was trimmed, given the downward movement in the WCA Fundamental Conditions Index™ (see page 5). Proceeds were reallocated toward intermediate-term Treasuries.

- High-yield corporate bonds and REITs provide some higher yield, while Treasuries offer some counterbalance to the higher credit risk in corporate bonds and REITs.



Investment Posture

The CONSERVATIVE PORTFOLIO invests between 0-50% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 25% stocks and 75% bonds. This portfolio offers the most conservative mix of stocks and bonds relative to the other portfolios mentioned herein. Investors with a short-to-medium investment horizon of at least 5 years or lower risk tolerance who desire modest growth may prefer this option over a portfolio with greater exposure to stocks.

- In the last quarter, emerging markets and small cap exposure was trimmed, given the downward movement in the WCA Fundamental Conditions Index™ (see page 5). Proceeds were reallocated toward intermediate-term Treasuries.

- Corporate bonds and REITs provide some incremental yield over Treasuries within this diversified portfolio. Gold and international Treasuries provide some non-dollar exposure.

Sector Allocation

(Sector-Enhanced Portfolios Only)

	Portfolio Weight	S&P 500 Weight	Relative Weight
Energy	11.3%	12.3%	-1.0%
Technology	17.0%	19.2%	-2.2%
Materials	9.4%	3.6%	+5.8%
Industrials	11.3%	10.8%	+0.5%
Consumer Discretionary	17.0%	10.8%	+6.2%
Cyclical Sectors	66.0%	56.7%	+9.3%
Health Care	11.3%	11.8%	-0.5%
Utilities	11.3%	3.7%	+7.6%
Consumer Staples	11.3%	11.2%	+0.1%
Telecommunications	0.0%	2.8%	-2.8%
Financials	0.0%	13.9%	-13.9%
Non-Cyclical Sectors	33.9%	43.4%	-9.5%
Total	100%	100%	0.0%

Portfolio Changes

Fourth Quarter, 2011

	Conservative			Balanced			Moderate Growth			Aggressive Growth		
	Current	Prior	Change	Current	Prior	Change	Current	Prior	Change	Current	Prior	Change
Aggregate Bond Market	0%	0%	-	0%	0%	-	0%	0%	-	0%	0%	-
Cash & 1-3 Year Treasuries	11%	11%	-	2%	2%	-	2%	2%	-	18%	18%	-
3-7 Year Treasuries	19%	15%	4%	20%	17%	3%	14%	9%	5%	0%	0%	-
7-10 Year Treasuries	11%	11%	-	9%	9%	-	0%	0%	-	0%	0%	-
10+ Year Treasuries	0%	0%	-	0%	0%	-	0%	0%	-	0%	0%	-
Investment-Grade Corp	18%	18%	-	10%	10%	-	4%	4%	-	0%	0%	-
High-Yield Corporate Bonds	7%	7%	-	10%	10%	-	11%	11%	-	0%	0%	-
International Treasury	7%	7%	-	10%	10%	-	8%	8%	-	0%	0%	-
S&P 500	0%	0%	-	0%	0%	-	0%	0%	-	0%	0%	-
Large Cap Growth	7%	7%	-	12%	12%	-	26%	26%	-	39%	39%	-
Large Cap Value	4%	4%	-	8%	8%	-	13%	13%	-	14%	14%	-
Small Cap Growth	2%	2%	-	4%	4%	-	6%	6%	-	8%	8%	-
Small Cap Value	0%	0%	-	0%	0%	-	0%	0%	-	0%	0%	-
Developed Markets	0%	0%	-	0%	0%	-	0%	0%	-	0%	0%	-
Emerging Markets	0%	4%	-4%	5%	8%	-3%	5%	10%	-5%	8%	8%	-
Gold	10%	10%	-	6%	6%	-	6%	6%	-	8%	8%	-
REITs	4%	4%	-	4%	4%	-	5%	5%	-	5%	5%	-
Subtotal Bonds & Cash	73%	69%	4%	61%	58%	3%	39%	34%	5%	18%	18%	0%
Subtotal Equities & Other	27%	31%	-4%	39%	42%	-3%	61%	66%	-5%	82%	82%	0%
Total	100%	100%	0%	100%	100%	0%	100%	100%	0%	100%	100%	0%

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 NARIET. 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.