



September 30, 2010

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Tactical Allocation: Fourth Quarter 2010

Recently, we have seen some modest improvement in financial market performance, along with some of the economic indicators we track. However, the improvement is not pervasive across a wide variety of data, nor has it been sustained long enough for us to conclude that the economy is reaccelerating, or that heightened risk aversion is falling in a meaningful way. Simply put, analysis of market based indicators, and economic data is, at best, a mixed bag.

Against this backdrop, markets seem to be cheering the prospects for another round of asset purchases by the Federal Reserve, along with the falling dollar. We think this is short-sighted. What appears to be missing is a realization of the underlying causes driving the need for yet another round of asset purchases, and further dollar devaluation.

Contracting private sector borrowing and credit remains our primary concern, and debt overhang will take time to work off. Once again, we saw record levels of private sector debt liquidation in the second quarter, according to Federal Reserve data. Historically, this is not consistent with sustained increases in asset values, and economic expansion. As government spending has pulled back, and tax relief is nowhere in sight, signs of slippage in the economy have emerged. We have seen this in our diffusion indices, and the Federal Reserve sees it as well. In August, for example, they issued the following statement:

"Information received since the FOMC met in June indicates that the pace of recovery in output and employment has slowed in recent months."

For now, equity markets seem to be ignoring this slippage and are speculating on accelerating growth through next year. Alternatively, they are keying off shorter-term, transient relationships including a declining dollar. A declining dollar, it is reasoned, has the short-term benefit of raising prices, and stimulating export demand. We, however, see longer-term adverse consequences from this as it becomes harder to attract capital investment, and it saps purchasing power away from already stressed U.S. households. Furthermore, growing international discord over currency policies is potentially disruptive to global trade. Perhaps the more relevant message is coming from the U.S. Treasury market and gold markets which are outperforming equity markets this year. These trends, should they continue, would be clearly inconsistent with prosperity.

We have positioned portfolios in accordance with the data as seen through the lens of our diffusion indices (see page 6). Portfolio risk exposure is slightly below the middle of our strategic ranges at this time (see pages 4-5).

Economists vs. Strategists

Economists have ratcheted down their outlook for this year and next. According to the Philadelphia Federal Reserve's *Survey of Professional Forecasters*, prospects for the U.S. economy look weaker now than at the start of the third quarter, which is consistent with the slippage we've seen in our WCA Composite Conditions Index™ (see page 2). Economists stop short of predicting a double-dip recession, but the downshifting of expectations is a disappointment, especially since we should be seeing strongly accelerating expectations at this stage of recovery. So what exactly are these professional economists seeing for next year?

The consensus economist view is for continued slow growth that fails to bring the economy back to full employment any time soon...

Investment strategists have a more rosy view.

Economists see:

- ◇ **Growth in real gross domestic product** of 2.7%, which is a **decline** of 1% from last spring's forecast,
- ◇ **The unemployment rate** remaining well above the 5-6% full employment rate throughout their entire forecast horizon, which extends to 2013. In the third quarter, the average forecast for 2011's unemployment rate **was revised higher**, to 9.2% from 8.9%.
- ◇ **Inflation forecasts are moving lower** for both headline and core consumer prices. The expected forecast for the consumer price index for 2011 was lowered to 1.8% from 2.0%, and the expected change in core consumer prices (excluding food and energy) dropped to 1.5% from 1.6% last spring.

The consensus economist view is for continued slow growth that fails to bring the economy back to full employment any time soon. Also, they see the slack allowing for continued low inflation and exceptionally low interest rates.

Investment strategists have a more rosy view. A recent Bloomberg survey shows just how optimistic Wall Street investment strategists are compared to their economist counterparts.

Strategists see:

- ◇ **An average 16% rise in the S&P 500** in a range of 0-36% between now and the end of 2011.
- ◇ **Profit growth of 15%** to an average 2011 forecast of \$87 in a range of \$80-95.

So you can see from these two divergent postures some of the dichotomy that exists between two different groups of forecasters looking out to next year. Perhaps the fact that the stock market is not a perfect proxy for the economy, and vice-versa, explains some of the divergence in views.

Another possible explanation of the divergent views held by strategists compared to economists is that strategists tend to be focused primarily on corporate profitability, because that is the primary interest of investors. Here, the strategists can legitimately point to 30% growth in profits in the last year and high profitability as profits reach peak levels as a percent of GDP. They can also point toward large cash positions, stock buybacks, and dividends as talking points.

By contrast, the economists are confronted with more laborious and weighty issues. A wide range of intractable issues from ongoing private sector deleveraging, ballooning deficits, taxation, monetary dilemmas, and banking reform simply makes strategists much better company than economists these days.

Another oft forgotten but critical opinion is that of actual entrepreneurs and business owners. Here, we continue to see that small business confidence is very low, but less dismal than in early 2009. The National Federation of Independent Businesses index, which measures small business sentiment, remains at a very low level (the index is at 88 with a high of 108 in 2004 and a low of 81 in March 2009). Another survey of CEOs conducted monthly by *CEO Magazine* also shows that confidence is nearer the low end of the historic range (the index is at 89, with a high of 182 in 2004 and a low of 39 in early 2009). Notably, the rate of improvement in business confidence has stalled recently.

As a result of heightened concern, business executives have made their companies lean and mean. Record levels of cutbacks in employment, coupled with low levels of investment spending, have been designed to work off excess capacity in the face of poor demand. Recent slippage in order rates, rising inventory, and weak forecast demand suggest accumulating slack that could prompt further cutbacks. Add concerns about slowing government spending, mounting pension and healthcare obligations, higher regulation and taxes, and it is easy to see why businesses have adopted a more conservative posture.

Couple this with fresh memories of the shutdown in credit and capital markets, and executives are keen to pad their coffers with whatever available capital they can borrow at historically low interest rates while they can. Thus, despite low interest rates, and weak demand, business attitudes are far from ebullient. Instead, a more defensive posture has resulted in high profitability (profits as a percent of GDP are near a record 10%), modest capital investment (capital expenditures as a percent of GDP are down to a very average 6.6% of GDP), and a pile of "rainy day" cash (non-financial company cash holdings have risen by 90% since 2000 to \$1.7 trillion). In this profile, profits ARE being maximized, investment IS occurring, and balance sheets ARE healthy, but for all the wrong reasons.

So you can see that economists and strategists are both right in what they see. The economy is extremely challenged, which means that job and income growth will suffer. At the same time, businesses are hunkering down in the absence of demand, and in the presence of excess capacity. Shareholders have benefited from cost-cutting, but at the expense of future demand. We're all in this together.

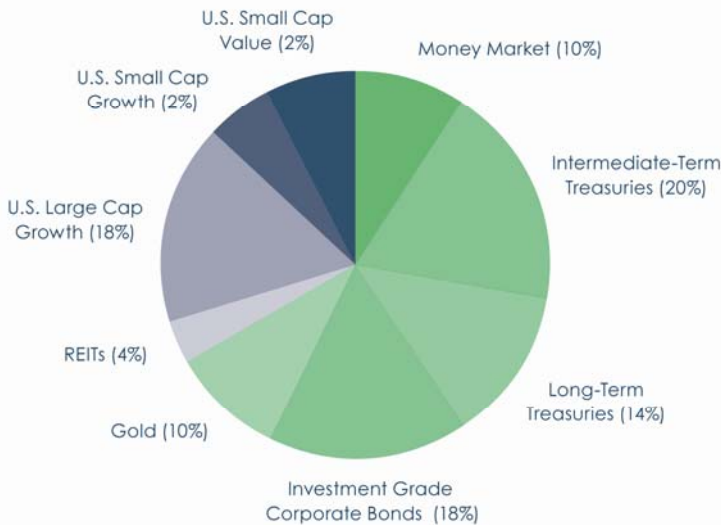
... businesses confidence is very low, but less dismal than in early 2009...

Notably, the rate of improvement in business confidence has stalled recently.

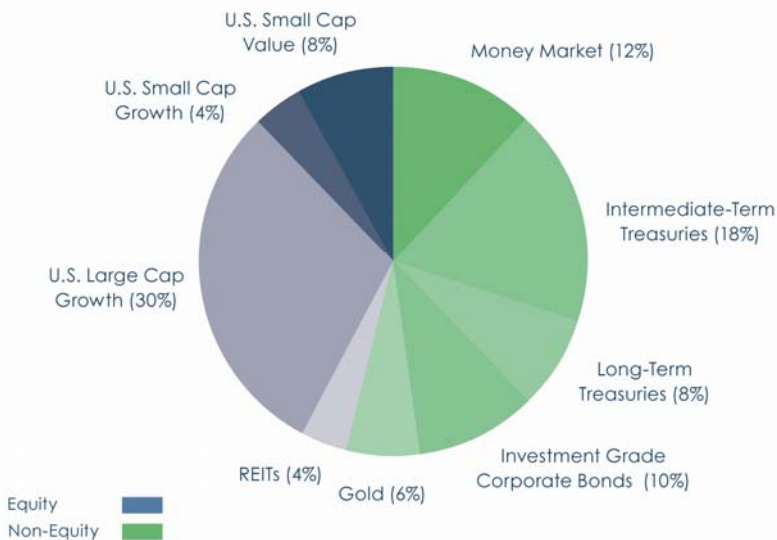
... profits ARE being maximized, investment IS occurring, and balance sheets ARE healthy, but for all the wrong reasons.

Recommended Model Portfolios

Conservative Portfolio Allocation
 Equity Policy Range: 0-50%
 Current Equity Exposure: 28%
 September 30, 2010



Balanced Portfolio Allocation
 Equity Policy Range: 25-75%
 Current Equity Exposure: 46%
 September 30, 2010



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...

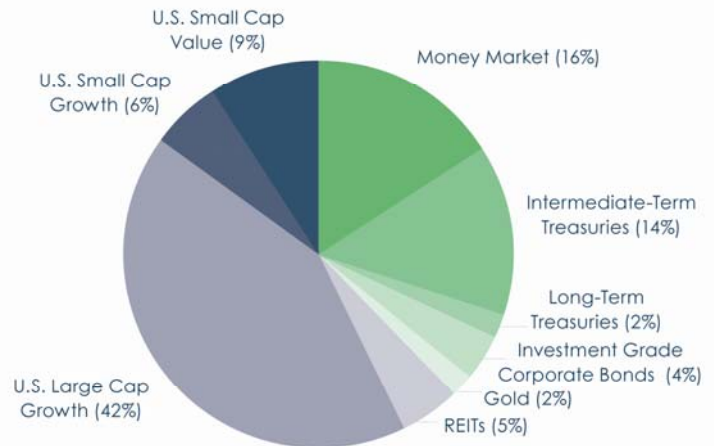
Balanced

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...

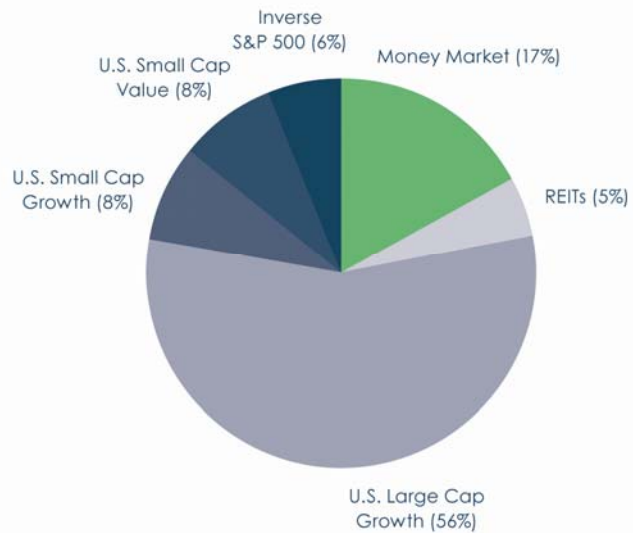
Growth Portfolio Allocation
Equity Policy Range: 50-100%
Current Equity Exposure: 62%
September 30, 2010



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 is an effective complement to an existing bond portfolio...

Aggressive Portfolio Allocation
Equity Policy Range: 75-100%
Current Equity Exposure: 83%
September 30, 2010



Diffusion Indices Update

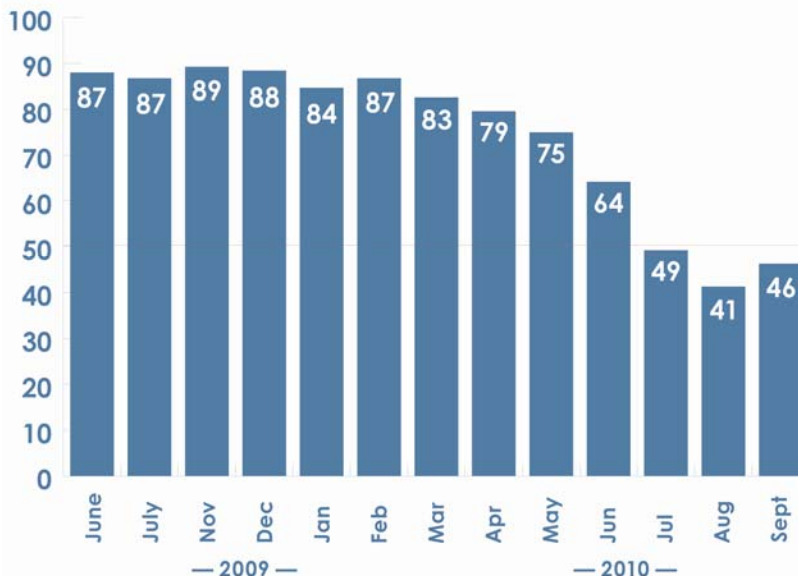
We update our investors quarterly about the status of our various indicators. These are “diffusion-style” indices designed to identify what percentage of the indicators under examination are rising or falling. The credit, U.S. economic, and foreign indices each summarize the performance of ten indicators 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™ fell to 44
- ◇ WCA U.S. Economic Conditions Index™ fell to 70
- ◇ WCA Foreign Conditions Index™ fell to 25
- =====
- ◇ WCA Composite Index™ fell to 46

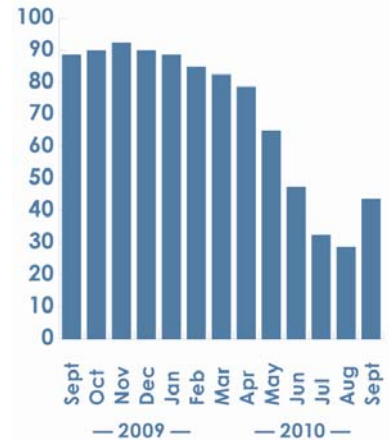
Given the level and trend in our WCA Composite Index™, we have adopted a less aggressive portfolio posture from a year ago when the index was above 50, with improving trends. In just the past few weeks, there has been a slight improvement in the WCA Credit and Capital Markets Index™ and the WCA U.S. Economic Conditions Index™. However, the improvement is neither broad-based, nor demonstrated sufficient sustainability to warrant a material shift in asset allocation at this time.

WCA Composite Conditions Index™

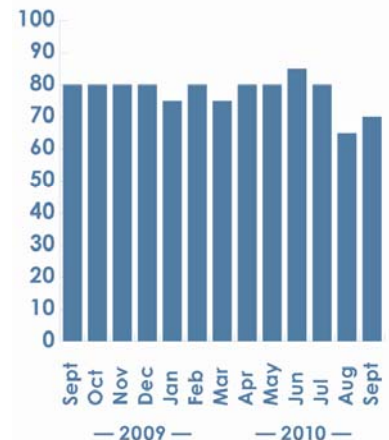
Last 12-month readings



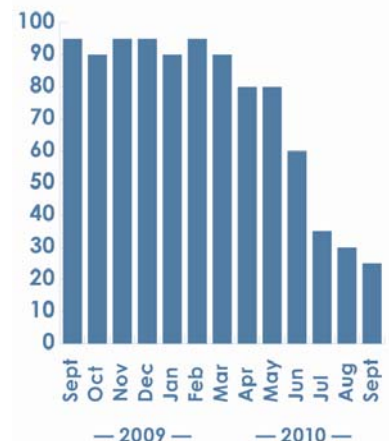
WCA Credit Conditions Index™



WCA U.S. Economic Conditions Index™



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

We measure performance in weeks, not days. We believe that this perspective is appropriate, since we are not engaging in active trading, and that by maintaining a broader perspective, our goal of identifying and capturing significant, sustained market trends over time is possible.

Tactical Trends

Notwithstanding September's equity market rally, the broader trends seem to be away from risk toward the relative safety of bonds. Coinciding with the bond leadership over stocks has been the very strong performance of gold, which also is typically bought as a hedge against risk. Both long-term Treasury bonds and gold have returned approximately 20% this year – far surpassing global equity market returns of near 0%.

This "risk aversion" trade began sometime in May and is still intact as we measure things. This trend has, therefore, been in place for four months. Bond-led markets generally arise out of some kind of generalized fear and typically last for a year or more (although there have been a couple of occasions, such as late 1987, when they fizzled out after a few months).

As for sub-asset category trends, we have seen sustained bullish trends in gold, emerging markets, and Treasuries. We have been long gold, and Treasuries, and would be interested in adding emerging markets given improvement in global trade and production trends (see our WCA Foreign Conditions Index™). With regard to the U.S. equity portion of the portfolio, we have trimmed back our exposure to small-cap relative to large as small-cap leadership has faded. The style emphasis has also been returned to growth, which has begun to outperform value (typically this happens later in the business cycle as investors seek earnings growth ahead of a cyclical downturn).

The non-equity portion of portfolios contains cash, long-term Treasuries, gold, and investment grade corporate bonds based on relative performance and the trend in our WCA Composite Conditions Index™.

Snapshot of Market Trends in Recent Months:

- ❖ Stocks vs. Bonds – Bonds Leading
 - Stocks
 - Value or Growth – Growth Leading
 - Small Stocks or Large Stocks – Mixed
 - Foreign or Domestic – Mixed
 - Emerging or Foreign – Emerging Leading
 - Bonds
 - Corporates or Treasuries – Treasuries Leading
 - Long or Short Duration Treasuries – Long Duration Leading
 - High Grade or High Yield Corporates – High Yield Leading
 - Foreign or Domestic Sovereign – Domestic Leading
 - Currency
 - Trade Weighted Dollar – Falling
 - Dollar Price of Gold – Rising (Established Trend)

Sector Allocations

	Portfolio Weight	S&P 500 Weight	
Energy	0.0%	11.1%	(10.7%)
Technology	13.3%	18.6%	(18.8%)
Materials	0.0%	3.6%	(3.4%)
Industrials	13.3%	10.9%	0.8%
Consumer Discretionary	16.7%	10.4%	5.8%
Cyclical Sectors	43.3%	54.7%	(26.3%)
Health Care	10.0%	11.5%	(12.1%)
Utilities	13.3%	3.6%	12.3%
Consumer Staples	20.0%	11.2%	7.4%
Telecommunications	13.3%	3.2%	13.0%
Financials	0.0%	15.8%	4.9%
Non-Cyclical Sectors	56.7%	45.3%	26.5%
Total	100.0%	100.0%	0.0%

The model sector portfolio remains overweight non-cyclical sectors, owing to the fact that our WCA Composite Conditions Index™ is below 50 and still in a negative trend.

During the last quarter, Financials again began to underperform the broader market while technology and healthcare showed some signs of relative performance. Financials, which tend to benefit from a steep yield curve, have seen a flattening of the Treasury yield curve of approximately 150 basis points over the past six months. This coupled with increased capital requirements, tighter regulation, higher capital requirements, and potential for further write-downs (especially if the economic and housing recovery falter) are all part of the bearish argument against financials, and may explain some of the renewed relative price performance in financials of late.

On the other hand, the positive relative price performance by healthcare and technology companies is consistent with movement toward sectors that may have the ability to grow earnings despite a slow economy.

The Telecommunications, Utilities, Consumer Staples, Consumer Durables, and Industrial sectors continue to show strong relative performance versus the S&P 500. Energy and materials sectors, which have been laggards for most of the year, have begun to show some signs of improving momentum and are being added to our “watch list.”

Portfolio Changes: Third Quarter 2010

September 2010 Removed financial exposure on deteriorating relative performance in sector enhanced model

September 2010 Added Healthcare and Technology exposure on stronger relative performance in sector enhanced model

September 2010 Style shift to growth from value due to weakening economic growth prospects and relative performance

July 2010 Added inverse S&P 500 (aggressive only) to align portfolio risk with WCA Composite Conditions Index™

July 2010 Further reduced risk / equity exposure in line with further drop in WCA Composite Conditions Index™

July 2010 Rebalanced Portfolios to Model

July 2010 Added Telco, Utilities, Staples \ Pared Back Consumer Discretionary, Industrial, Financial

July 2010 Bought 7-10 Year Treasuries \ Pared Back Large Cap Value, Sold Mid Cap Value, Eliminated TIPs

Watch List

Recovery Durability

Impacts: Stocks vs. Bonds; Cyclical vs. Defensive Sector Exposure. WCA Composite Conditions Index™ is below 50, and trend is negative. Therefore, we have adopted a less aggressive portfolio posture from a year ago when the index was well above 50, with improving trends. At the margin, there has been a slight improvement in the WCA Credit and Capital Markets Index™ and the WCA U.S. Economic Conditions Index™ during the month of September. However, the improvement is not broad-based, nor has it proven to be sustained over a meaningful time period.

Emerging Markets

Performance has improved relative to U.S. equity market performance, which is consistent with signs of strength in some industrial metal prices and other commodities. Emerging markets have grown to 25% of world equity market capitalization from less than 10% five years ago.

Commodity-Linked Sectors

Energy and basic material sectors have underperformed the S&P 500 over the past several quarters. However, relative valuations on normalized earnings are improved, and the groups have recently begun to show some signs of relative price momentum.

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.