# WASHINGTON CROSSING ADVISORS

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October 2011

# Tactical Allocation: Fourth Quarter 2011

## Europe Takes Center Stage

In the past quarter, markets were forced to confront Europe's sovereign debt crisis, the potential effect that crisis might have on banks, and the potential for resulting slower growth. The crisis threatens bank stability, and rising bank stress tends to drive a generalized reduction in global risk appetite. Markets are anticipating a restructuring of Greece's debt, a recapitalization of weakened banks, and the expansion of funding mechanisms to provide liquidity to the region. Further details on these plans will be forthcoming in the next few weeks. Ultimately, the deeper structural issues will likely require some form of fiscal integration between Euro-bloc member states, and greater coordination of economic policy will be necessary, but the road to that eventuality is a long one.

### What's next for Europe?

Europe will be forced to make hard decisions addressing the restructuring of Greek debt, increasing the leverage and size of the European Financial Stability Facility (EFSF), and the need to recapitalize the banking system. These are all thorny political issues to navigate, and each decision requires cooperation that is slow in coming. Instead of a sweeping agreement, a halting and piecemeal process appears more likely.

Markets are particularly concerned that Greece may default on its debt. The Greek government appears to be falling short of targets for deficit reduction and asset sales. Additional loan amounts to help continue funding the country's growing shortfall are becoming politically unpopular in fiscally conservative countries. Consequently, the potential for a Greek default has risen, and it is likely that private banks and other investors will have to bear a greater portion of the costs of a Greek restructuring. Whether or not Greece receives its next round of funding should be decided upon in the next several weeks.

Meanwhile, national parliaments across Europe are in the process of ratifying changes to the €440 billion European Financial Stability Facility (EFSF). Proposed amendments would permit the fund to be used in bank recapitalizations and to buy the debt of struggling member countries like Italy and Spain, if needed. There is also some more controversial discussion of allowing the leveraging of the fund to increase its potential firepower. Again, this solution does not get to the structural issues confronting Europe, but provides stopgap measures to quell market fears. As with the slow progress on Greece, the political process for ratifying the fund's rules is frustratingly slow in an era of fast-moving markets. As with the Greek decision, the EFSF ratification should come in late-October or early-November.

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STIFEL NICOLAUS

*Despite the confidence shock from August and September's market drama, the U.S. economy performed reasonably well, judging by recent data…*

### The Long View on the EU

Looking out a bit further, there are a few broad ideas circulating about how to provide greater stability to Europe. Ideas include the issuance of Euro-area bonds and fiscal integration across Euro-member states. There is also an important debate about whether fiscal policies would be dictated by an overarching supranational entity, or decided upon by an inter-governmental body. There is great uncertainty about the political feasibility and timetable of such an idea. The European Commission and European Council have begun the debate, but a long road to acceptance lies ahead, since these ideas encroach on individual country sovereignty.

### Back at Home

Despite the confidence shock from August and September's market drama, the U.S. economy performed reasonably well in August and September, judging by recent data. The U.S. economy added 42,000 private sector jobs in August and 137,000 private sector jobs in September. September automobile sales grew by 9%, with 13 million units sold, at an annualized rate. The Institute for Supply Management's manufacturing survey also held steady at a level that suggests tepid, albeit continued, expansion.

### Rates to Near Record Lows

While stocks have had a rough go recently, it is worthwhile noting that bonds have surged. Starting with a yield of about 4.5% in March, long-term Treasuries rose sharply through the end of September and drove the 30-year Treasury yield below 3%. 10-year Treasury yields are now below 2% (from 3.5% in March), and the average 30-year conforming mortgage rate is now near a record low 4%.

All of this happened despite the end of the Fed's second bond buying program ("QE2") in June, and the first-ever downgrade of U.S. debt in August. Rather than focus on those seemingly "bond-unfriendly" factors, bond markets focused instead on "bond-friendly" factors including a worsening Europe, slowing global growth, a strengthening dollar, and anticipated further action by the Fed, which came in the form of the Fed's recently announced "operation twist." The resulting drop in interest rates should provide an incremental boost to activity in the months ahead.

Episodes of S&P 500 Underperformance vs. LT Treasury Bonds by > 40% in Six Months

| Date | Relative Return Bonds vs. Stocks | Next 6 Months Relative Return | Next 12 Months Relative Return |
|---|---|---|---|
| Sep-31 | -39% | -21% | -19% |
| Apr-32 | -51% | +21% | +50% |
| Mar-38 | -39% | +45% | +27% |
| Sep-02 | -47% | +4% | +20% |
| Dec-08 | -67% | +34% | +59% |

### Risk Priced In?

Although significant challenges remain, it appears that markets have moved quite a way toward recognizing them. Based on the performance of stocks (the "risk" asset) compared to bonds (the "fear" asset), there has been a significant market recognition of risk. From March through the end of September, the S&P 500 generated a negative -14% return compared to long-term U.S. Treasuries, which returned a positive +34%, for a near 50% performance disparity.

This is a large divergence for such a short period of time. By our measurements, this sort of performance discrepancy only happened a few times in modern history (see table). It happened twice in the 1930s (1932-1933 and 1938), and it happened twice in the 2000s (2001-2002 and 2008). This year's most recent episode is, therefore, historically significant and has pushed the "equity risk premium" (difference between the S&P 500 earnings yield compared to the Treasury yield) to new highs in what has been a multi-year trend (see chart). Should markets and economic growth begin to stabilize, this resetting of prices could provide fuel for additional upside in equities.

### Portfolio Posture for Tactical Model Portfolios

Risk has been pared back beginning last spring, and model portfolios are tilted more toward bonds within strategic ranges. We are watching for signs of stabilization in fundamental conditions before returning portfolios to a more fully invested "neutral" posture with greater equity exposure.

The WCA U.S. Economic Conditions index remains near 50, a level consistent with moderate growth, but the more volatile Credit and Foreign Conditions components of our WCA Fundamental Conditions Index have both fallen below 50. The composite WCA Fundamental Conditions Index™ is near 32, based on preliminary data. Accordingly, model portfolio beta has been reduced from last spring as we await signs of fundamental stabilization.

Current tactical "biases" include:

1) Portfolio exposure is tilted away from stocks toward bonds;
2) No European equity exposure;
3) Bond maturities are shorter than usual;
4) Foreign equity exposure remains below target allocation;
5) Small cap exposure is below our strategic target allocation;
6) Heaviest equity exposure is large cap growth.

**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.

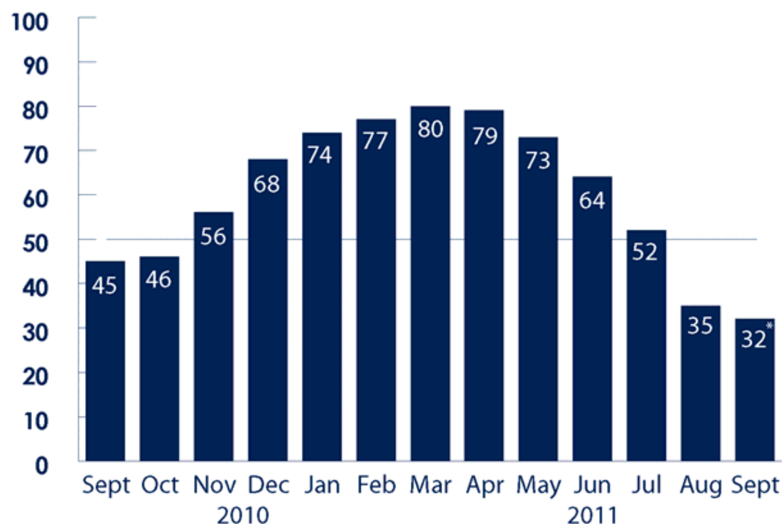
# Update on Fundamental Conditions

The fundamental backdrop is mixed. Credit conditions and foreign indicators have fallen to levels more typical of deteriorating fundamentals, while the data on the domestic economy remain at a level suggestive of modest growth. 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.

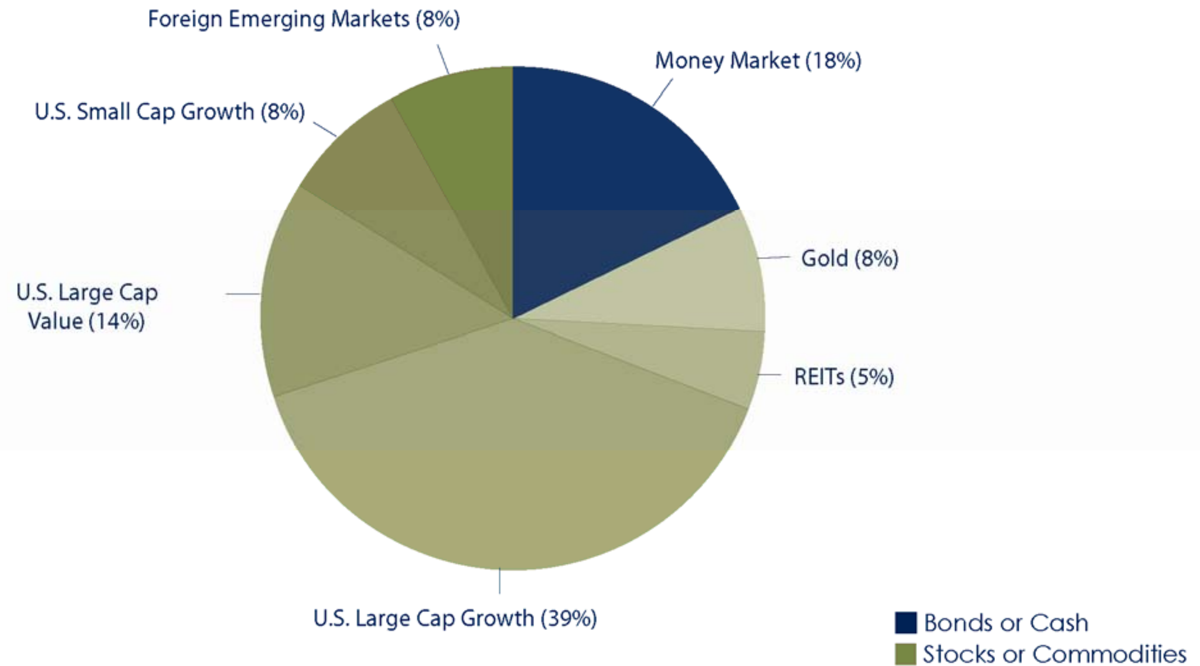
## WCA Indices*

*>50 Favors Stocks / <50 Favors Bonds*

| | Last | Current | Change | Summary |
|---|---|---|---|---|
| Credit & Capital Markets | 60 | 20 | - | Falling, Faster rate |
| U.S. Economic Conditions | 75 | 45 | - | Falling, Slower rate |
| Foreign Conditions | 65 | 30 | - | Falling, Slower rate |
| Fundamental Conditions | 64 | 32 | - | Falling, Slower rate |



**Aggressive Portfolio Allocation**
Equity Policy Range: 80-100%
Current Equity Exposure: 82%
September 30, 2011




## 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, emerging markets and small cap exposure was trimmed to be consistent with the downward movement in the WCA Fundamental Conditions Index™ (see page 4). Proceeds were reallocated toward cash and gold.

- Fundamental conditions in the U.S. slipped in the third quarter. We would like to see signs of stabilization before reallocating to a more bullish posture with equity exposure at or above the midpoint of the portfolio's equity policy range.

- Largest concentration at the end of the quarter was domestic large cap growth.

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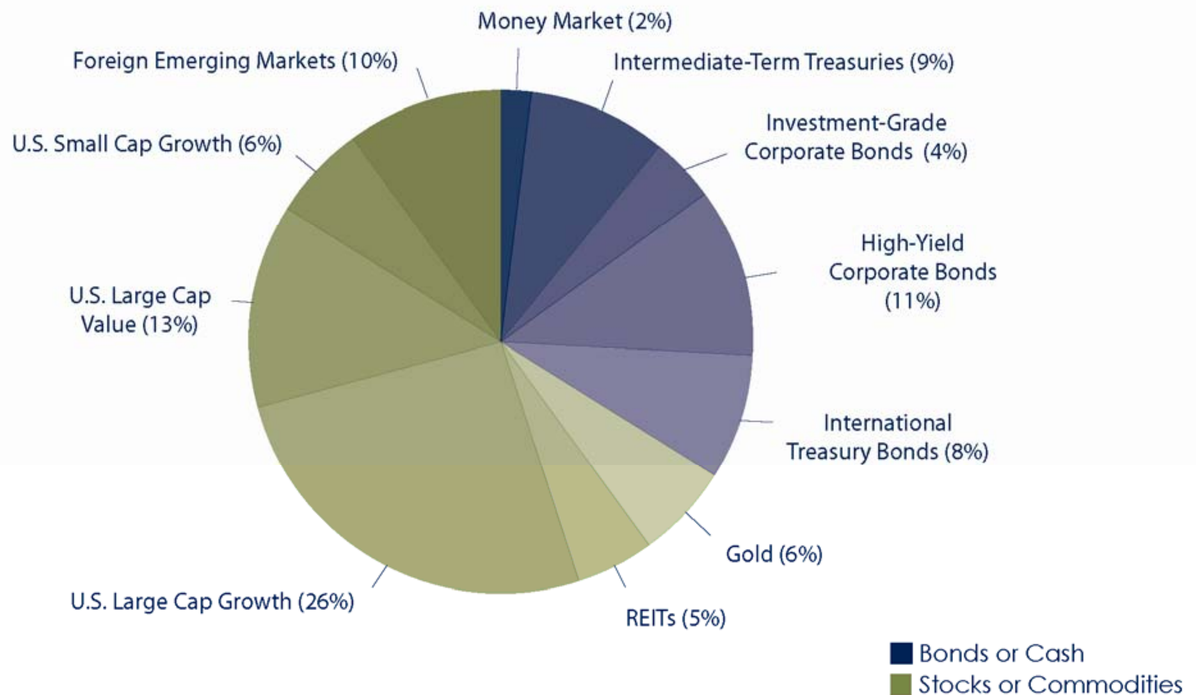
**Moderate Growth Portfolio Allocation**
Equity Policy Range: 50-100%
Current Equity Exposure: 66%
September 30, 2011

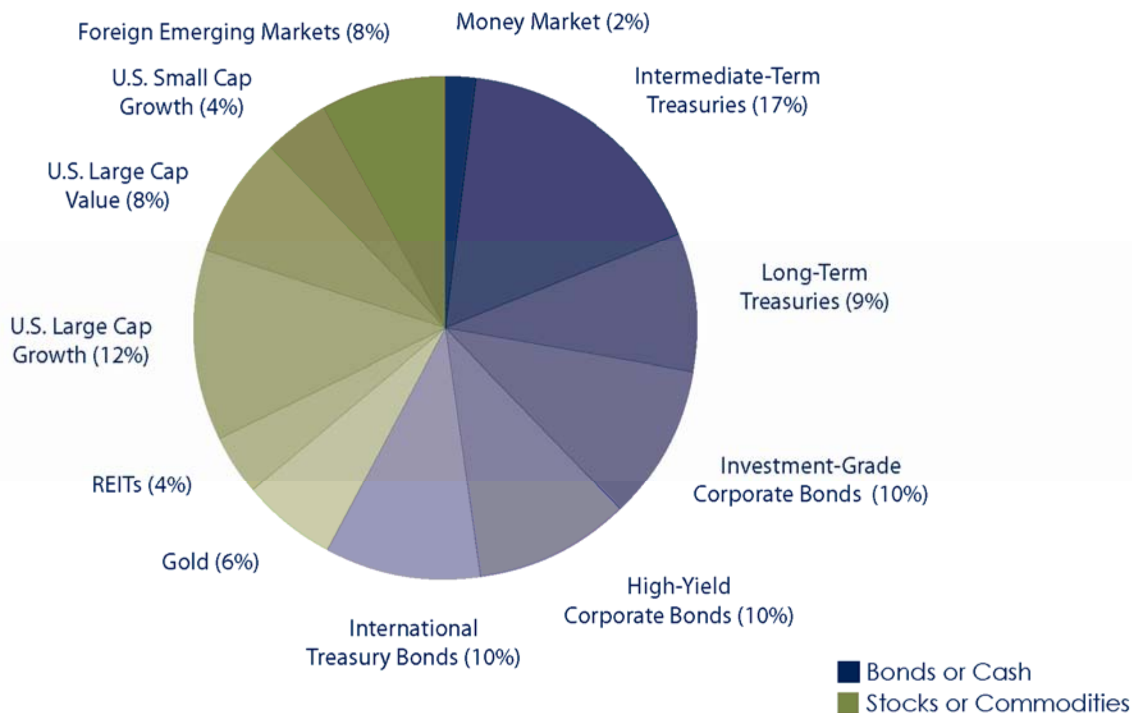



## Investment Posture

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 in keeping with the downward revision of the WCA Fundamental Conditions Index™ (see page 4). Proceeds were reallocated toward intermediate duration Treasuries and gold as we await signs of stabilization in fundamentals.
- High-yield corporate bonds and REITs still provide a flow of income into the portfolio at rates above that provided by Treasuries.
- Fundamental conditions in the U.S. slipped in the third quarter. We would like to see signs of stabilization before reallocating to a more bullish posture with equity exposure at or above the midpoint of the portfolio's equity policy range.

**Balanced Portfolio Allocation**
Equity Policy Range: 25-75%
Current Equity Exposure: 42%
September 30, 2011




## 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.

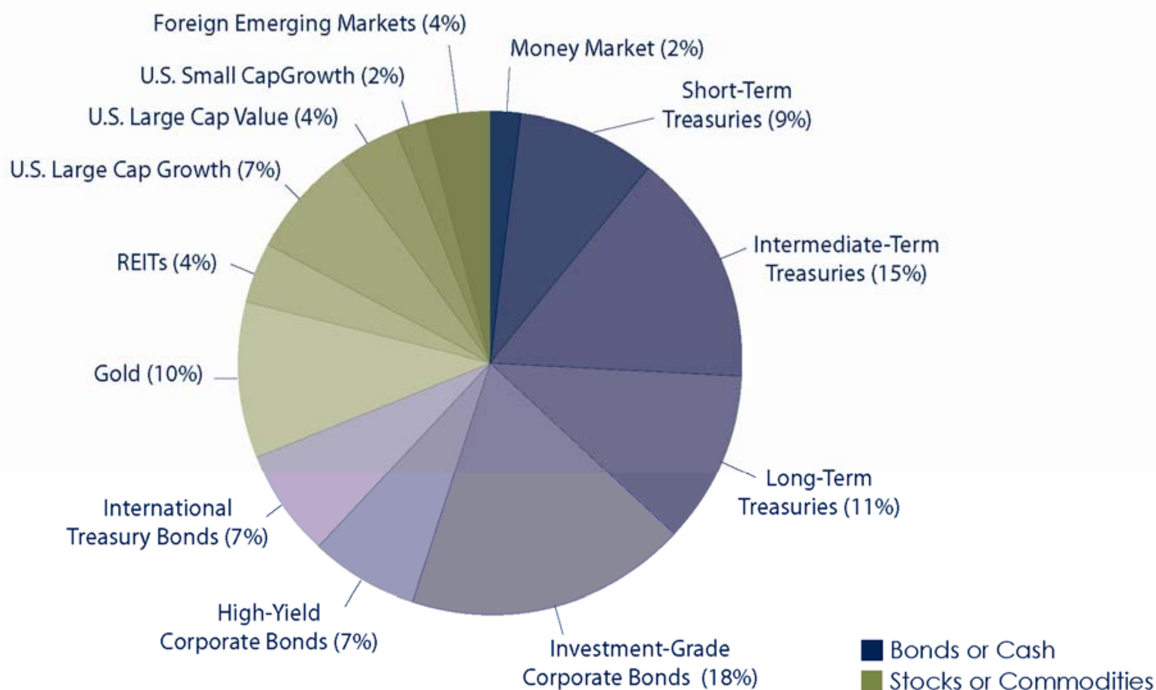
- This portfolio is broadly diversified across stock and bond markets. Exposure to non-dollar denominated assets is included alongside dollar denominated stocks, bonds, REITs, and gold. Bond duration was trimmed as long-term Treasury yields fell below 2%. The portfolio is currently allocated below its "neutral" position for stocks and bonds in keeping with the WCA Fundamental Conditions Index™ (see page 4).

- Fundamental conditions in the U.S. slipped in the third quarter. We would like to see signs of stabilization before reallocating to a more bullish posture with equity exposure at or above the midpoint of the portfolio's equity policy range.

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

## Conservative Portfolio Allocation

Equity Policy Range: 0-50%
Current Equity Exposure: 31%
Sepember 30, 2011




### 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.

- More bonds were added during the quarter due to weakness in the WCA Fundamental Conditions Index™ (see page 4). The duration of the bond portfolio was shortened as long-term Treasury yields fell toward historic lows.

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

- Fundamental conditions in the U.S. slipped in the third quarter. We would like to see signs of stabilization before reallocating to a more bullish posture with equity exposure at or above the midpoint of the portfolio's equity policy range.

# Sector Allocation

## (Sector-Enhanced Portfolios Only)

| | Portfolio Weight | S&P 500 Weight | Relative Weight |
|---|---|---|---|
| Energy | 11.3% | 11.9% | -0.6% |
| Technology | 0.0% | 19.7% | -19.7% |
| Materials | 9.4% | 3.5% | +5.9% |
| Industrials | 11.3% | 10.4% | +0.9% |
| Consumer Discretionary | 17.0% | 10.8% | +6.2% |
| Cyclical Sectors | 49.1% | 56.3% | -7.2% |
| Health Care | 11.3% | 11.8% | -0.5% |
| Utilities | 0.0% | 3.8% | -3.8% |
| Consumer Staples | 11.3% | 11.4% | -0.1% |
| Telecommunications | 17.0% | 3.1% | +13.9% |
| Financials | 11.3% | 13.6% | -2.3% |
| Non-Cyclical Sectors | 50.9% | 43.7% | +7.2% |
| Total | 100.0% | 100.0% | 0.0% |

# Portfolio Changes

## Third Quarter, 2011

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