WASHINGTON CROSSING ADVISORS

October 2012

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Tactical Allocation: Fourth Quarter 2012

The Election, the Debt, and the Fiscal Cliff

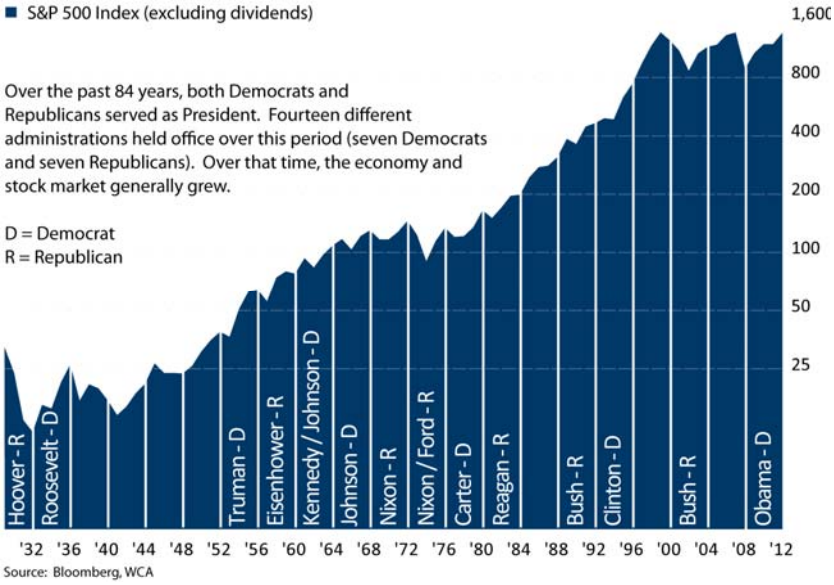
No matter who wins the November election, changes are coming that matter to investors. What does an Obama win or Romney win mean for the markets? What about the nation's debt and the deficit? How might taxes change? How might planned cuts in government spending impact the financial environment? All of these questions represent unknowns that have an effect on markets and portfolios.

The Election

From a market perspective, the record presents a mixed picture when it comes to Democrats and Republicans. Over the past 84 years and 14 Presidents, the economy and stock market both grew. Excluding dividends, the market returned about 7%. Over shorter periods, many factors other than politics will determine how markets and the economy will perform, however.

Right now, there is a great deal of uncertainty in the market. Europe's ongoing recession and sovereign debt crisis, concerns about the upcoming "fiscal cliff," a potentially volatile situation in the Middle East, and slowing growth in China are all but a few causes for concern. These uncertainties and others like them throughout the ages dampen confidence and growth. The passing of the election should, at least, bring about some clarity about the road forward and eliminate some of the uncertainty currently in the markets.

Presidents and the Stock Market



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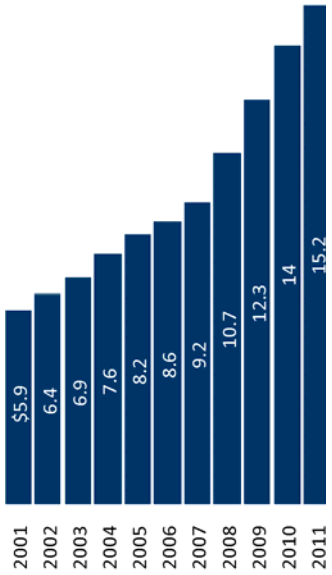
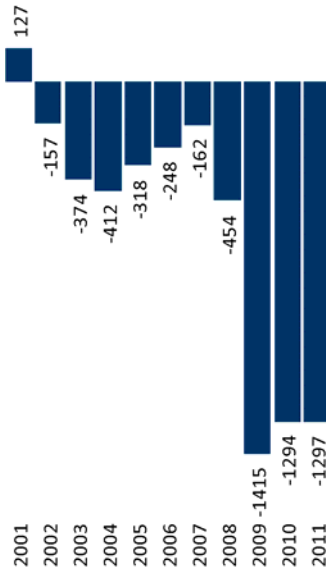
Treasury Debt ($ Trillions)



Federal Deficit ($ Billions)



Source: Bloomberg

The Fiscal Cliff

Whoever wins the Presidency will have to confront a sure change of direction on national economics. Even before the new Congress is seated or the President-elect takes the oath of office, cuts in spending and increases in taxes are set to take place. Like it or not, Washington will confront a sizable shift in economic policy regardless of who becomes President and who controls Congress.

Under current law, a significant fiscal contraction would take place. A payroll tax cut is scheduled to kick in, removing $120 billion of disposable income. Jobless benefits are scheduled to be cut by $40 billion. Bush-era tax cuts will be removed, effectively raising taxes by $83 billion on those earning over $250,000 per year and by $198 billion on those earning less than $250,000 per year. Taxes relating to the Affordable Care Act will kick in, resulting in a $46 billion net fiscal contraction. Lastly, a mandated sequestration of spending related to last year's debt-ceiling negotiations is set to reduce federal spending by roughly $90 billion. All told, the combined fiscal drag from all this amounts to as much as $577 billion (or 3.8% of GDP).

Handicapping the outcome of the fiscal cliff budget negotiations has become a popular pastime on Wall Street. Estimates range from a 1% drag on GDP to the full 3.8%. It is obvious that the current pace of deficit and debt accumulation is not sustainable indefinitely (debt has grown rapidly in recent years – chart top left). Since 2008, the economy has expanded by about $280 billion per year. However, the deficit (and, hence, the debt), has grown at an average rate of $1.1 trillion per year (chart bottom left). Some combination of smaller deficits and faster growth are necessary to prevent the ongoing rise in the debt to gross domestic product ratio that lies at the heart of last year's first-ever rating downgrade of United States Treasury obligations.

It is anybody's guess what lawmakers will ultimately agree to as a way to shrink the deficit. What is clear is that, in the absence of an economic "emergency," it is very hard to maintain large deficits. The hard questions over what to cut and who to tax are moving front-and-center. For a Congress that has recently been unable to find compromises, the threat of a replay of last summer's debt ceiling debacle looms large. A close election and a divided government could lead to a more protracted debate with greater uncertainty, while a clear mandate from the electorate will yield a more expedient resolution to the debt debate.

What to Do Now?

Maintaining a balanced approach is important during times like these. Although our expectation is for gradually improving fundamental conditions, potential pitfalls exist. We continually incorporate new information into our outlook, and there is potential for changes (both positive and negative) headed into the new year. For now, we maintain a fairly balanced approach that recognizes the risks as well as the potential for fundamental improvement ahead.

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

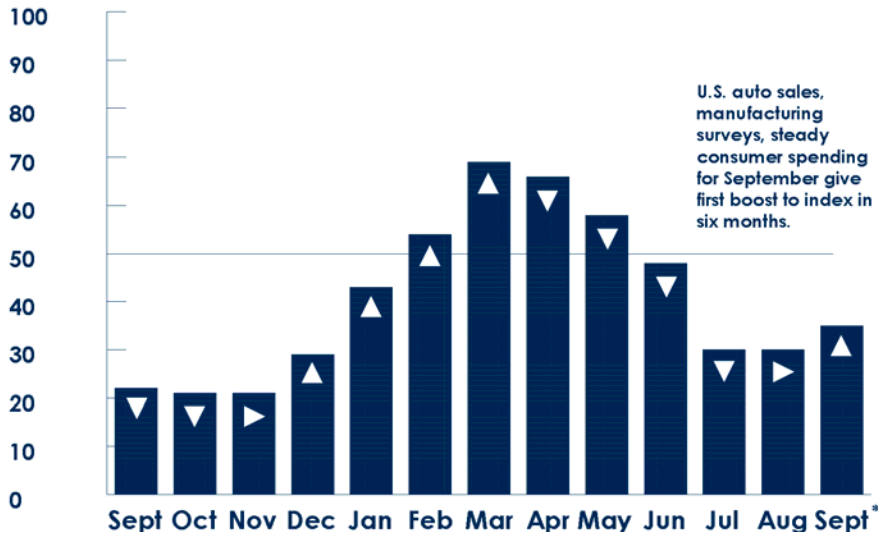
Fundamental conditions were weak in the third quarter, but September data provided some encouraging signs. Manufacturing activity, automobile sales, and employment appear advanced in September, helping the overall picture. At the same time, foreign manufacturing may be near a bottom. Our expectation of improving fundamentals going forward will have to be demonstrated in the data week to week.

The introduction of new monetary stimulus by central banks gave a boost to riskier assets and backstopped some of Europe's higher cost debt. Although the interpretation of price signals from equity and debt markets are fundamentally hard to interpret, one immediate effect is access to capital at attractive terms. This helped contribute to September's boost.

WCA Fundamental Trend Indicators

	Last Quarter	Current (Preliminary)	Change
Credit & Capital Markets	58	56	-
U.S. Economic Conditions	45	35	-
Foreign Conditions	40	15	-
Fundamental Conditions	48	35	-

WCA Fundamental Conditions "Barometer" 1-Year



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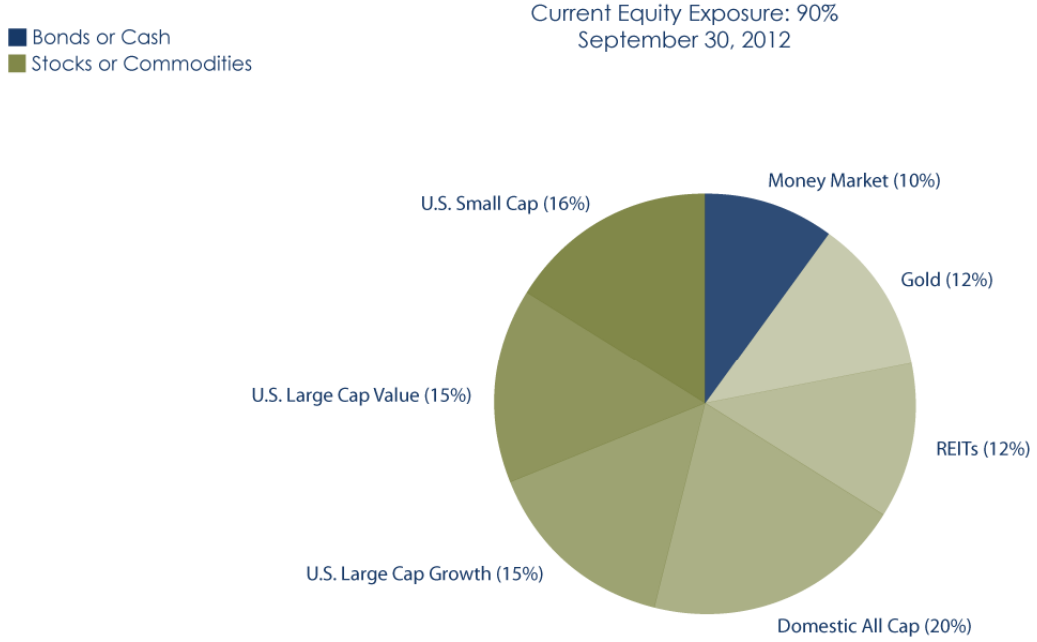
Aggressive Portfolio Allocation

Equity Policy Range: 80-100%
Current Equity Exposure: 90%
September 30, 2012



Increasing Risk ---------->

Conservative	Balanced	Moderate Growth	Aggressive Growth

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.

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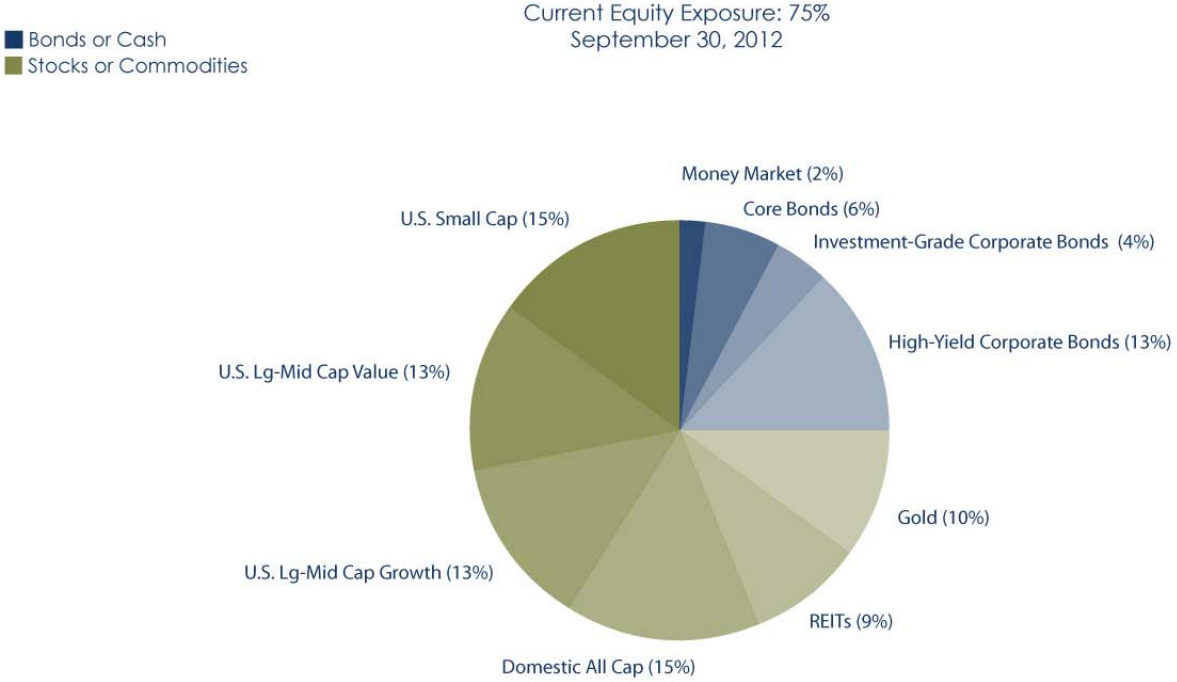
Moderate Growth Portfolio Allocation

Equity Policy Range: 50-100%
Current Equity Exposure: 75%
September 30, 2012



Increasing Risk ---------->

Conservative	Balanced	Moderate Growth	Aggressive Growth

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.

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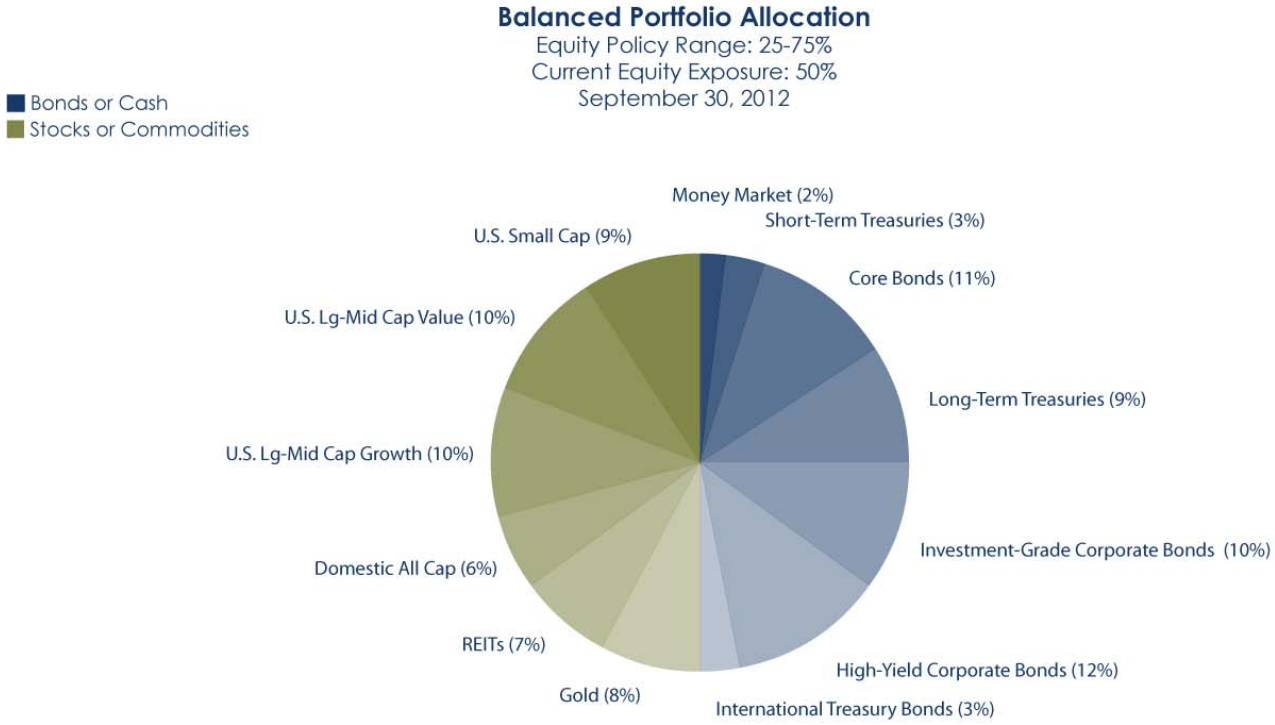

Increasing Risk ---------->

Conservative	Balanced	Moderate Growth	Aggressive Growth

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.

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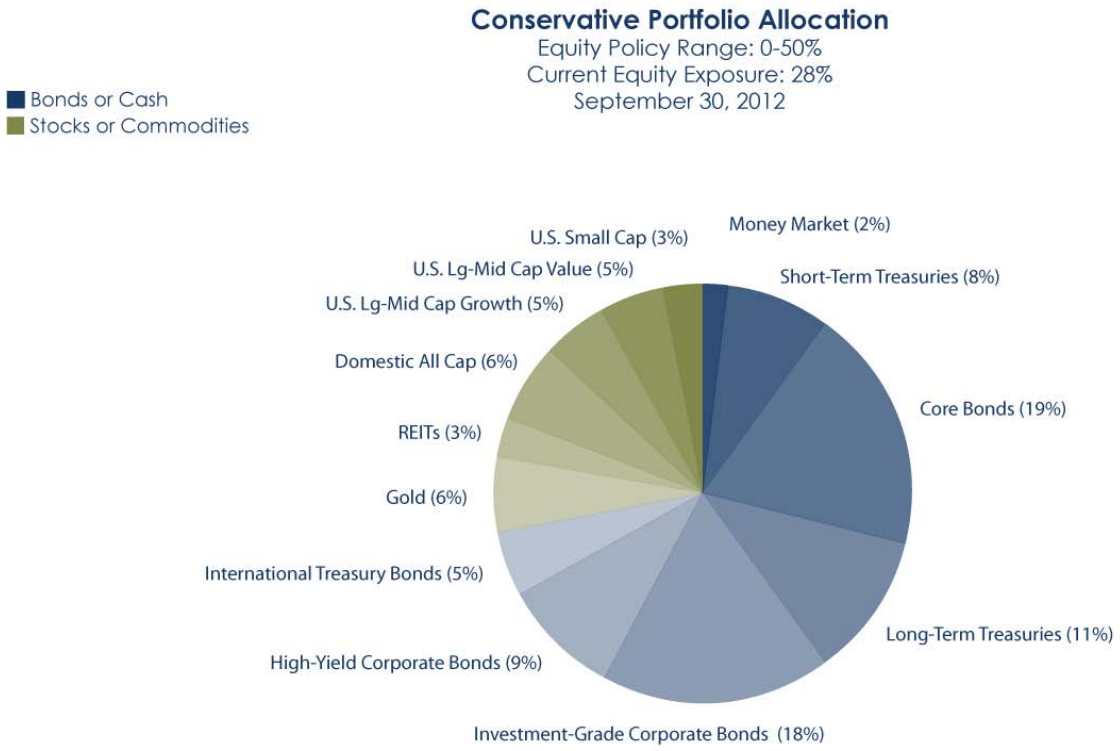


Increasing Risk ---------->

Conservative	Balanced	Moderate Growth	Aggressive Growth

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.

Sector Allocation

	Portfolio Weight	S&P 500 Weight	Relative Weight	Comment
Energy	30%	11%	+19%	Potential for growth rebound a positive
Technology	23%	20%	+3%	Tech spending still outpacing GDP growth
Materials	0%	3%	-3%	Underperforming / slowing China demand
Industrials	0%	10%	-10%	Underperforming / slowing China demand
Consumer Discretionary	10%	11%	-1%	Continued steady U.S. consumer spending
Cyclical Sectors	63%	55%	+8%	Improving fundamentals favor cyclical
Health Care	13%	12%	+1%	Performing better and below market multiple
Utilities	0%	4%	-4%	Attractive yield / little growth
Consumer Staples	17%	11%	+6%	Attractive yield / steady growth
Telecommunications	0%	3%	-3%	High multiple / high yield / high leverage
Financials	7%	15%	-8%	Slack lending / regulation / opacity
Non-Cyclical Sectors	37%	45%	-8%	Rising barometer favors cyclical at present
Total	100%	100.0%	0.0%	

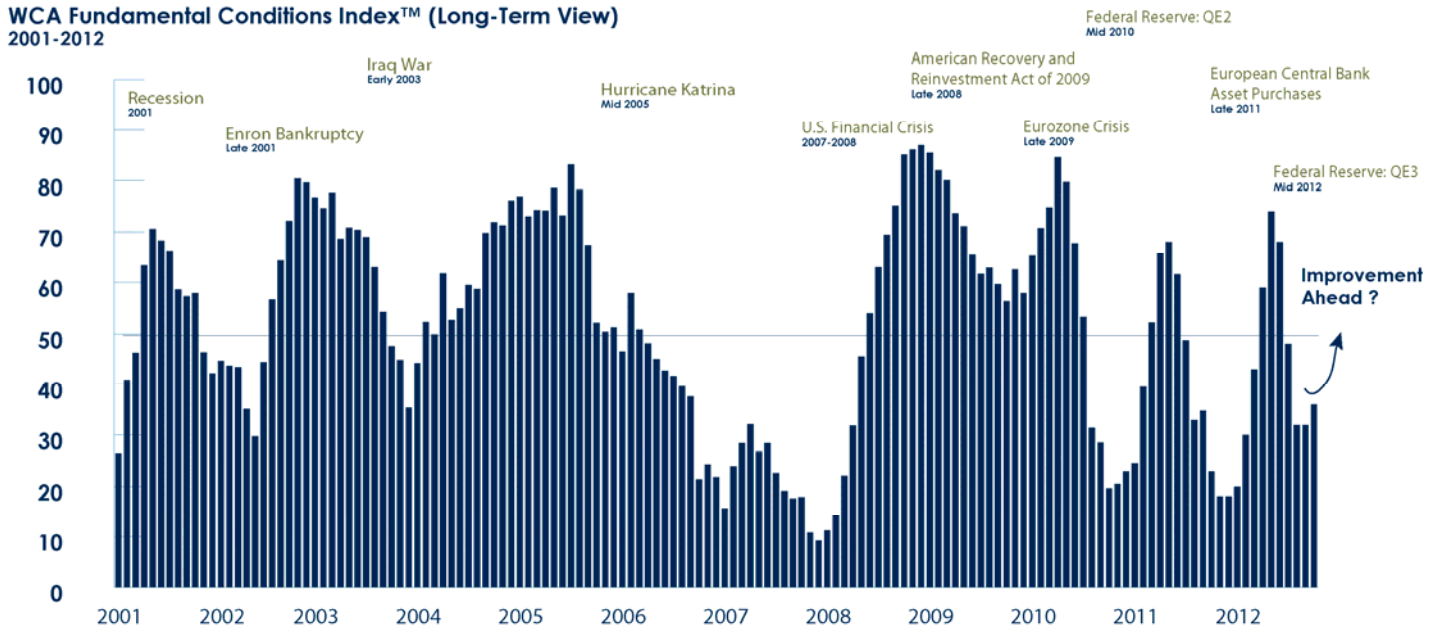
Portfolio Changes

Third Quarter, 2012

	Conservative		Balanced		Moderate Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Core Bonds	19%	3%	11%	6%	6%	6%	0%	-
Cash & 1-3 Year Treasuries	10%	-	5%	-	2%	-	10%	6%
3-7 Year Treasuries	0%	-	0%	-	0%	-	0%	-
7-10 Year Treasuries	11%	-	9%	-	0%	-	0%	-
10+ Year Treasuries	0%	-	0%	-	0%	-	0%	-
Investment-Grade Corp Bonds	18%	-	10%	-	4%	-	0%	-
High-Yield Corporate Bonds	9%	-	12%	-	13%	-	0%	-
International Treasury Bonds	5%	-	3%	-	0%	-	0%	-
Domestic Stocks	6%	-	6%	-	15%	9%	20%	14%
Large-Mid Cap Growth	5%	-	10%	-	13%	-	15%	-
Large-Mid Cap Value	5%	-	10%	-	13%	-	15%	-
Small Cap Growth	3%	-	9%	4%	15%	5%	16%	4%
Developed Markets	0%	-	0%	-3%	0%	-8%	0%	-10%
Emerging Markets	0%	-3%	0%	-7%	0%	-12%	0%	-14%
Gold	6%	-	8%	-	10%	-	12%	-
REITs	3%	-	7%	-	9%	-	12%	-
Subtotal Bonds & Cash	72%	3%	50%	6%	25%	6%	10%	6%
Subtotal Equities & Other	28%	-3%	50%	-6%	75%	-6%	90%	-6%
Total	100%	0%	100%	0%	100%	0%	100%	0%

A Long-Run View

These long-run expectations are the starting point for asset allocation. Events will inevitably take place that cannot possibly be anticipated or forecast, and as a result, these expectations will almost certainly change over time. To help identify such changes in the investing environment, we constructed The WCA Fundamental Conditions Index™ seen below. It is similar to a barometer that focuses on changes in financial market and the economic trends. We believe that combining a long-run strategic outlook with shorter-term tactical observations represents a practical method for addressing uncertainty and change in the short run without losing sight of the longer term.



Over the long run, we believe that deleveraging in the private sector will keep unemployment rates high and inflation and interest rates low. Developed nations, including the United States, Europe, and Japan, are most affected. To combat deleveraging and potential deflation, aggressive, sustained, and coordinated efforts by central banks to reflate should eventually lead to a higher overall price level. Away from the developed world, emerging markets should see rising demand for commodities and a growing consumer class. Growth and investment returns in these economies should, therefore, outstrip the growth and return profiles of many developed economies.

Cash and other short-term instruments remain very low through 2016, and central banks should move gradually to normalize interest rates beyond 2016. Spreads on corporate bonds relative to Treasuries may narrow in the intermediate term, but longer-term returns will be constrained by already low Treasury yields. Higher-yielding corporate bonds should generate income returns that are above high-grade corporate bonds and Treasuries, but expect higher volatility.

Large capitalization domestic stocks should generate high-single-digit long-run returns driven by three key factors. These factors include earnings per share growth, dividend yield, and some modest multiple expansion. Corporate earnings per share should rise faster than domestic output due to cost discipline, rising demand from emerging economies, and technological innovation. Technology, healthcare, and consumer sectors are logical beneficiaries of these trends. Corporate tax policy is expected to be neutral to positive. Dividend yields should rise due to cash flow and earnings growth and some increase in the dividend payout ratio. Small to mid-sized firms should benefit from acquisition activity by larger companies with a growing cash hoard and the potential for smaller firms to grow faster and adapt more quickly to change than large companies.

Real estate is likely to provide above-trend longer-run returns given recent underperformance. Commodities and Gold should provide returns near global GDP growth with potential near-term variations strongly affected by inflation expectations.

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."

The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

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."