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Tactical Allocation: Third Quarter 2010

The word "vigilante" derives its meaning from the Latin word "vigil," which means "awake" or "observant." It was during the last quarter that global bond and currency markets awoke with alarm to the magnitude of public sector leveraging that had occurred in the wake of the financial crisis. With budget deficits around the world often at or above the 10% mark, investors have decided to take matters into their own hands and demand a new level of fiscal discipline from the countries that prove to be profligate spenders. In a sense, this renewed vigilance puts a limit on government determination to generate higher spending and, hence, calls into question the risk and reflation trade that began in early 2009. While the flashpoint for the recent sell-off was Greece, Portugal, Spain, and Italy, attentions are also shifting to the United States, where mid-term elections will soon take center stage.

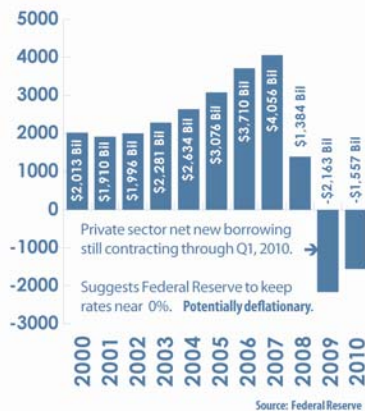
The United States appears increasingly alone in the spending club. Austerity measures have been ushered in across Europe, while China is taking measures to reign in bank lending to ease a growing property bubble. U.S. Federal spending rose by 18% (\$536 billion) in 2009, to a total of \$3.5 trillion (24% of GDP) and is expected to stay above 24% of GDP through 2011. The recent rate of increase was three times faster than the growth in average spending over the previous 10 years. Of course, this spending needs to be financed, and that requires more debt.

Since the financial crisis began in the second half of 2007, the total debt owed by U.S. Federal and State governments has increased by 50%. That 50% increase in three years has raised debt to \$10.5 trillion (72% of GDP) from \$7.1 trillion (50% of GDP). The Congressional Budget Office also expects Federal debt to level off as a percent of GDP moving forward. Mirroring the debt level, the CBO also expects this year's fiscal deficit to be \$1.35 trillion (9.2% of GDP) and mark the peak level of deficit in dollar terms as deficits fall back to \$475 billion (2.7% of GDP) by 2014. Average annual deficits of \$600 billion are forecast from 2011 through 2020, and will require an additional \$6 trillion of debt to cover the shortfall. Markets are beginning to question the sustainability of this strategy.

Given the existing slack in the system, heightened market disdain for financing endless deficits, and mounting internal and external political pressures, it is less certain that governments will be capable of generating a level of spending that generates the kind of inflation that policy makers associate with asset price stabilization, increased credit demand, and a rising velocity of money. Without this, the reflation and risk trade comes under fire, which is exactly the message that market vigilantes made loud and clear in recent months.

In a larger context, the failure (so far) for traditional policy tools to lift the economy's "animal spirits" points to a stark reality...

Private Sector Net Borrowing Contracts



That's All Folks!

Although we have seen an improvement in economic data over the past year, it has been impossible to ferret out sustainable private initiative from temporary government spending programs. Whether it was "cash for clunkers" or the \$8,000 first-time homebuyer tax credit, a vast array of transfer payments and spending was thrown at the economy to gin up demand. With short-term interest rates also lowered to effectively 0%, a powerful cocktail of spending and credit creation provided a shock to the system, which prevented a further slide in the economy, and caused a sharp improvement in economic conditions in 2009 and into the first part of 2010. There were, we saw, sharp rallies in the global equity indices as investors saw government-backed risks in the credit market as a "sure thing" and equity markets lurched higher in tandem.

What is becoming apparent is that the private sector is not responding as it has in past recoveries to low interest rates. Borrowing is not up. Households are not borrowing more to buy homes. Small businesses are not opening their wallets and borrowing to fuel a new round of growth. Financial firms are still balance sheet constrained despite easier accounting rules and trillions of dollars of support and aid from Treasury, the Fed, and ultimately, taxpayers. All in, net new borrowing in the U.S. private sector was down in the first quarter at an annualized rate of over \$1.5 Trillion (see chart). Contracting net private sector borrowing is not consistent with an expectation for a "V" shaped recovery. What seems to have occurred in the data is that programs like "cash for clunkers," "cash for appliances," and the temporary \$8,000 homebuyer tax credit pulled forward future demand on the calendar, creating an illusion of improvement in the last year's data.

In a larger context, the failure (so far) for traditional policy tools to lift the economy's "animal spirits" points to a stark reality. That reality is that the state of over-indebtedness that existed in the private sector prior to the downturn is difficult to reverse, despite efforts by the private sector to raise savings and reduce debt. We saw, for example, that there was no net new borrowing in the aggregate private sector in the first quarter. This has not happened in this country since the 1930s depression. Despite the belt-tightening, we see that foreclosures continue to surge. Prior to 2006 and the 30% fall in national home prices, foreclosures seldom rose above 1% -- even during the early 1990s bear market in housing. Today, that number has exploded and is approaching 5%. Remarkably, 25% of mortgages remain underwater, and the S&P Case/Shiller 10-City composite index has fallen in five of the past six months. These are signs of a market that is still short of clearing.

Adding to pressure is a large number of bank-owned foreclosures. A recent study by Radar Logic, a real estate analytics firm, estimates that the U.S. government now owns 46% (or 219,060) of the supply of foreclosed real estate. Based upon this data, that would imply a total stock of "shadow inventory" of nearly a half a million units waiting to come onto the market at some point. This would add to the 4.1 million units currently on the market -- effectively pushing the total back up toward the 5 million peak level seen in 2007. When the last recovery got started in 2001, inventory stood at just over 2 million units.

These bank-owned properties carry implications for the banking system as well. If we assume that each of these homes carry a mortgage, and that mortgage is in the \$100,000 to \$200,000 range, the total value of impaired mortgage debt for just the pool of bank-owned properties could potentially range from \$50 billion to \$100 billion. Add to that the pressure on loan portfolios that will almost surely arise from trying to clear a market that, despite extraordinary measures, still carries an excess supply of unsold homes 2-3 million above the "normal" rate, and it seems clear that the process of clearing the housing, and related mortgage, markets are not yet complete.

In summary, the burden of excess debt, coupled with continued overinvestment in residential real estate, will most likely create additional downward pressure on prices. In terms of the larger monetary structure of the economy, the protracted growth of non-performing loans in the banking system suggests further contraction of loan portfolios, tighter standards for lending (despite central bank efforts to stimulate borrowing), and an increased possibility of deflation as credit contracts.

In this environment, real returns on fixed income are improved. Whereas in the past inflation tended to eat away at income returns, the current situation leaves more to investors. Deflation can also be seen as an improvement in the value of the dollar, since fewer new dollars are created through the credit expansion process that occurs when new borrowing is initiated in the banking system. Without rising net new borrowing, dollars become scarce and more valuable, which will tend to protect any gains from the ravages of high rates of inflation. While there are clearly signs of outright deflation in housing, consumer prices continue to rise, albeit modestly. The consumer price index, which measures price changes across an array of consumer items, is expected to rise less than 2% in the years ahead, based upon signals created in the bond market.

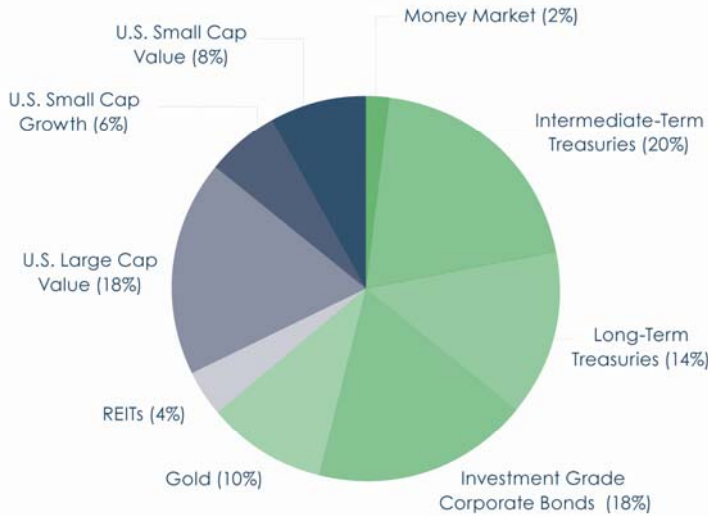
So we come full circle. The rapid expansion of credit and debt that fueled the housing bubble created the conditions for weaker growth. In the bubble, misallocation of capital into non-productive resources created malinvestment in real-estate that has yet to clear, because governments have intervened to prevent markets from clearing. In so doing, governments have sacrificed a certain degree of credit worthiness through additional borrowing, and further spending on other potentially non-productive activities.

We have seen some improvement in trade, production, employment, profits, and risk appetite over the past year. Beginning in January of this year, we curtailed exposure to foreign assets just as serious questions began to surface regarding the sustainability of government spending programs. We expect that the growth of global deficits and borrowing ended in the second quarter. Now the question becomes whether or not private initiative can carry the water from here. Which governments will step aside and improve the return on capital sufficient to induce private sources of capital to step up and make investments? Those that do this best will be the winners in a newly emerging global economy.

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Recommended Model Portfolios

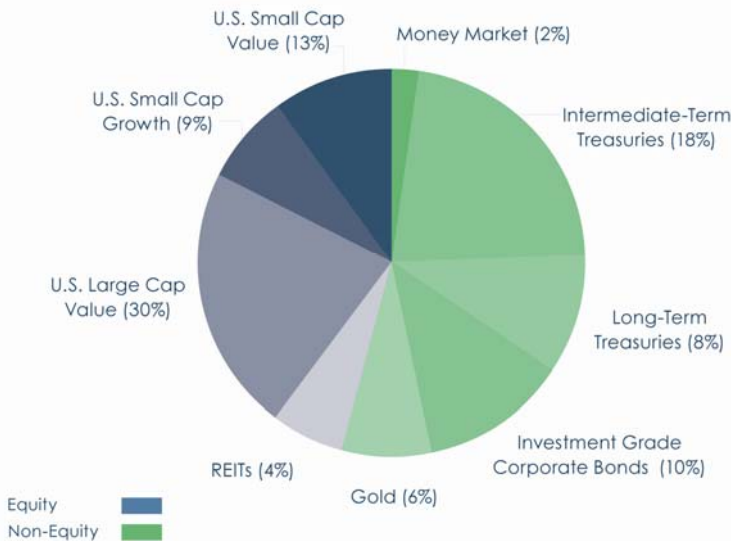
Conservative Portfolio Allocation
Equity Policy Range: 0-50%
Current Equity Exposure: 36%
July 1, 2010



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 Portfolio Allocation
Equity Policy Range: 25-75%
Current Equity Exposure: 56%
July 1, 2010



Balanced

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

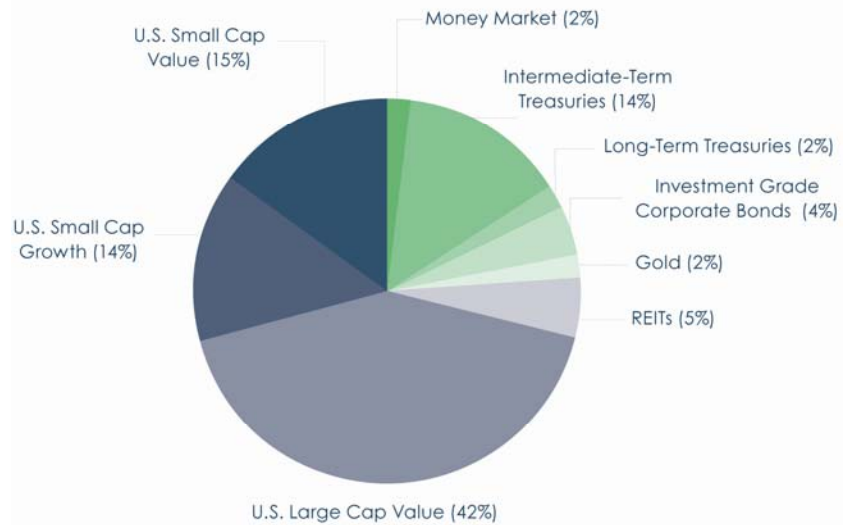
Growth

The target range of common equity exposure for the portfolio is **50-100%**. The portfolio invests primarily in equity funds. It is appropriate for investors with a longer time horizon and a high tolerance for risk...

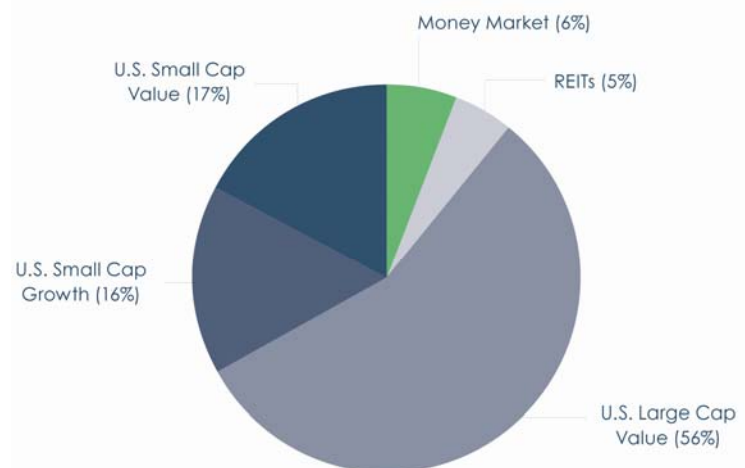
Aggressive

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

Growth Portfolio Allocation
Equity Policy Range: 50-100%
Current Equity Exposure: 76%
July 1, 2010



Aggressive Growth Portfolio Allocation
Equity Policy Range: 75-100%
Current Equity Exposure: 94%
July 1, 2010



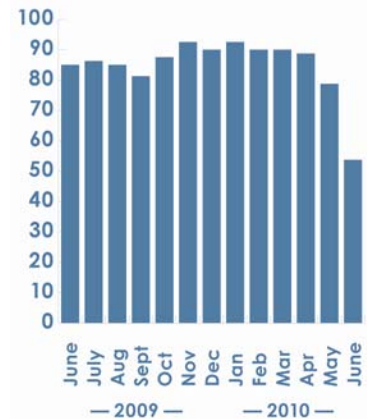
Diffusion Indices Update

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).

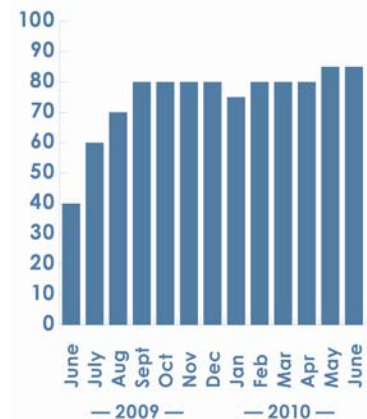
- ◇ WCA Credit Conditions Index™ fell to 55
 - ◇ WCA U.S. Economic Conditions Index™ remained near 80
 - ◇ WCA Foreign Conditions Index™ fell to 65
- =====
- ◇ WCA Composite Index™ fell to 67

The WCA Composite Index™ slipped to 67 during the last quarter, but remains above 50. The most leading of the three sub-indices, the WCA Credit Conditions Index™, fell to 54 as risk aversion rose. The WCA U.S. Economic Conditions Index™ saw continued progress. Foreign conditions slipped to 65 as risk appetite was curtailed and concerns about austerity measures and growth prospects reemerged.

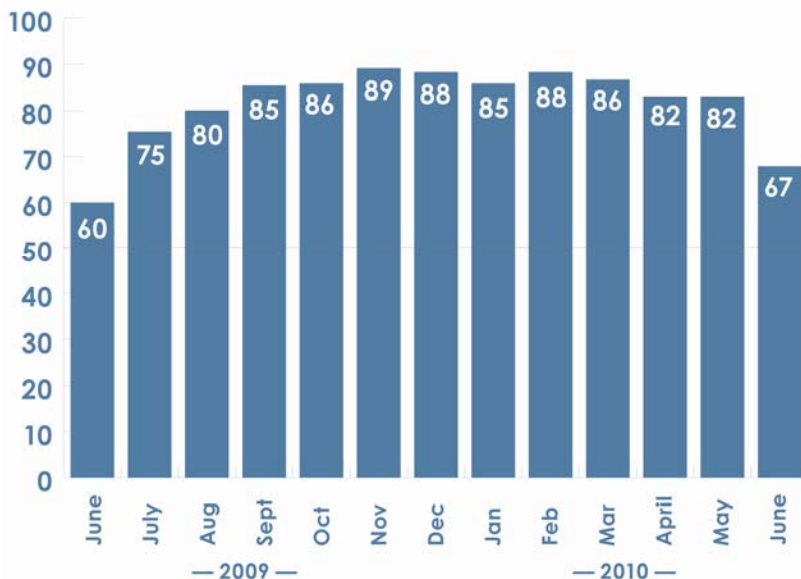
WCA Credit Conditions Index™



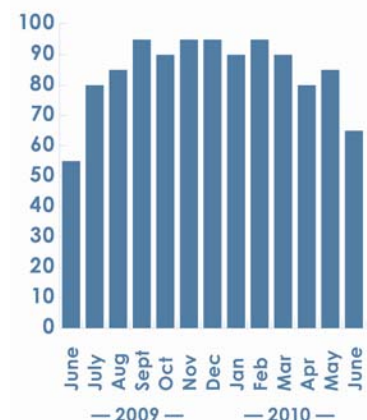
WCA U.S. Economic Conditions Index™



WCA Composite Conditions Index™
Last 12-month readings



WCA Foreign Conditions Index™



Cycles and Themes

Equities

Market Currents in Brief:

Domestic over Foreign

Small over Large

Value over Growth

*Emerging over
Developed*

*Government over
Corporates*

Long over Short Bonds

*Commodities over
Currency*

*U.S. Government Debt
over Foreign Debt*

The curtailment of government support for credit markets, coupled with the potential end of “hyper” growth in global government spending, dealt a harsh blow to credit markets, resurrected the prospect of systemic financial market risk, and tempered expectations for rapid economic recovery. Since our last quarterly update, five striking themes have emerged. These themes include:

Domestic issues outperforming foreign issues – For the year, dollar losses in U.S. equity markets are about half those borne outside the United States. The S&P 500, a measure of U.S. equity market performance, is down roughly 8% for the year at the time of this writing compared to the MSCI EAFE Index, which measures equity markets outside the United States, which is down 15%.

Value appears to be outperforming growth – The S&P 500 growth index has posted a negative total loss of -7% compared to the value index at -4%.

Defensive sectors appear to be improving – Defensive sectors, such as consumer staples, telecommunications, and utilities, seem to be performing better than cyclical sectors such as energy, materials, technology, and industrials.

Bonds, Cash, and Commodities

Bonds reasserting leadership relative to equities – The MSCI Global Equity Index fell by nearly 15% during the last quarter versus the 10-year U.S. Treasury, which rose by nearly 12% -- a 27% differential.

Shift to Treasuries and away from corporate bonds – The 10-year Treasury bond now yields 2.93%. At the end of April, yields were pushing 4%. At the same time, the yield spread on corporate bonds has risen to 313 basis points (3.13% over 10-year Treasuries) compared to 240 basis points in April.

Gold extends rally – During the quarter, gold advanced 11.6%.

Sector Allocations

	Portfolio Weight	S&P 500 Weight	
Energy	0.0%	10.7%	(10.7%)
Technology	0.0%	18.8%	(18.8%)
Materials	0.0%	3.4%	(3.4%)
Industrials	11.0%	10.2%	0.8%
Consumer Discretionary	16.0%	10.2%	5.8%
Cyclical Sectors	27.0%	53.3%	(26.3%)
Health Care	0.0%	12.1%	(12.1%)
Utilities	16.0%	3.7%	12.3%
Consumer Staples	19.0%	11.6%	7.4%
Telecommunications	16.0%	3.0%	13.0%
Financials	21.0%	16.1%	4.9%
Non-Cyclical Sectors	73.0%	46.5%	26.5%
Total	100.0%	100.0%	0.0%

Our sector exposure has shifted toward more defensive sectors. During the quarter, groups such as consumer staples, telecommunication, and utilities turned in a better relative performance versus the S&P 500. At the same time, growth sectors like technology, materials, and consumer discretionary lost some of the steam that they had exhibited in prior quarters.

Utilities currently offer a 4.7% dividend yield, with expected growth in the dividend of 5% over the next year. The group trades at 12 times expected earnings. The benefits derive from falling longer-term interest rates, but longer term we need to be mindful of changes in legislation regarding carbon emissions and how that plays out relative to electric utilities.

Having underperformed for over a year, Consumer Staples have turned in a better performance of late, having outperformed the S&P 500 by 3.5% in Q2. The group has among the most consistent earnings profiles of any of the 10 major sector groupings in the S&P 500, a net debt to cash flow ratio that is less than half that of the S&P 500, and earnings are forecast to grow at over 10% in the coming year. The 3.2% dividend is 110 basis points higher than the S&P 500 as well.

The Telecom sector also turned in a good quarter for the first time in quite a while, and appears to be putting in a better relative performance compared to the S&P 500 – bucking a long trend of underperformance. The yield on the S&P 500 telecommunication sector has risen to over 6%, providing some income return to income-seeking investors. The sector trades at 12 times forward earnings that are expected to grow at a modest 5% in the year ahead.

Portfolio Changes: Second Quarter 2010

April 2010: Due to a material break in the relative performance of foreign equity and currency markets, coupled with renewed downward pressure on commodity prices, emerging markets were removed from portfolios.

May 2010: Long-term Treasuries were added to the portfolio on May 24 with proceeds from the sale of high yield corporate bonds on May 20. This was done as Treasuries were showing improving stronger relative performance versus the aggregate bond market compared to high yield credits which had begun to lag.

Also during the month, we moved our growth exposure into value. This is a reversal of a call we made in July 2007, where we made a strong case for growth. After several months of stabilization, value is outperforming growth.

July 1, 2010: Added to Treasuries via 7-10 year Intermediate Term Treasuries, and reduced large cap value.

Portfolios were also rebalanced back to model.

Watch List

Recovery Durability

Impacts: Stocks vs. Bonds; Cyclical vs. Defensive Sector Exposure

Emerging Markets

Although we eliminated emerging markets from the portfolio early in the second quarter, performance of late has improved relative to U.S. equity market performance.

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.