

By: Andrew Douglas, VP and Chief Investment Officer, Wealth Management Group

****We are changing our Strategic Asset Allocation to Neutral****

In the 4th quarter of 2008, we made the decision to underweight equities and buy fixed income. At the time, we had very strong convictions that bonds would perform very well, even if the economy stayed mired in a recession or if Treasury rates moved higher. Fast forward a year and the Barclays Aggregate Index has returned 13.79% over the past 12 months ending on October 31st (and up another 1% during November). As the bond market has continued to rally, our optimism for strong bond performance in 2010 has continued to fade. With 2 year and 5 year Treasury bonds yielding 0.66% and 2.01%, respectively, fixed income returns from cash flows have diminished. Going forward, price changes will constitute more and more of the total return of fixed income assets. For those who have seen our forecast presentation, you know we believe rates will be pressured to rise next year. Our forecast for returns on bonds in the low single digits for 2010 provides a very low hurdle for outperformance. As our preference for bonds has lessened, our outlook on equities has increased slightly. While the market has rallied 60%+ from the bottom in March, the market is not wildly overvalued. Our models (and intuition) show the market is fairly valued on a short-term basis and undervalued long-term (>3 years). With stock market return estimates in the mid to upper single digits for 2010, a neutral stance becomes more reasonable.

One of the questions we constantly ask ourselves as we invest our clients' money is, "what if we are wrong?" The market is still in a very fragile state, as witnessed by the reaction to the Dubai World debt news. Our long-term economic outlook is very subdued, with a very weak consumer at the epicenter of our sub-normal growth forecasts. However, when we look at upside surprises, the probabilities are heavily weighted towards equities. Cost cutting has left businesses very lean, which means any incremental gains in revenues will mostly flow to the bottom line. And when one is investing in the stock market, one has to remember it is valuing companies, not the economy (even though they are obviously highly correlated). Plus, we have implemented and are implementing several new strategies to further diversify our portfolios. We have already added a volatility strategy to our WIS portfolios and an interest rate cap strategy to our actively managed fixed income accounts. With this strategic change, we will be establishing a 5% alternative asset allocation to a market neutral fund for all our non-SRI clients¹. This allocation will bring further risk reduction and a natural hedge against a lower stock market.

Even though the markets have had a strong year, investing is still a very difficult task. As the markets have changed over the course of 2009, the risks to both stocks and bonds have balanced out. In this environment we believe a neutral allocation makes the most sense, with some hedges put in place against downside risk. As always, we will continue to monitor the situation and make changes as appropriate.

¹ As with our other alternative assets, the market neutral fund will not be placed in accounts with a Bonds IO (unless otherwise directed).