

Mid-Year Outlook

2010



Tacking Into the Headwinds

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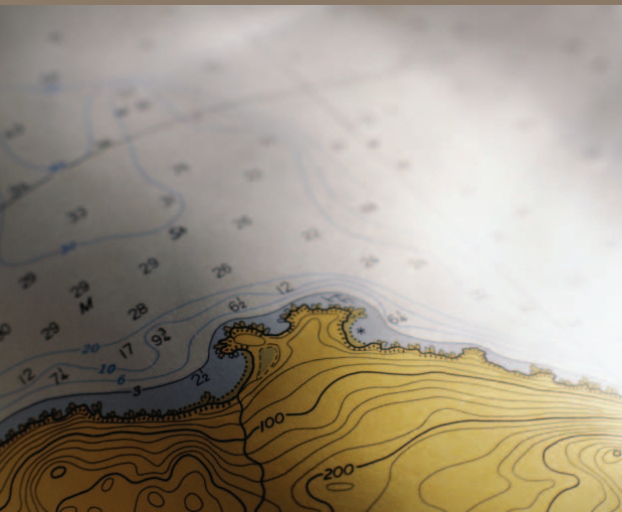
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2010

Mid-Year Outlook Tacking Into the Headwinds

We expect the economy and markets will stay on the course for growth in 2010. We are maintaining our forecasts for the year:

- U.S. economy grows 3–4%, with growth slowing in the second half of the year to a below average 2–3%
- Stocks post modest single-digit gains on solid earnings growth, accompanied by high volatility
- Bonds post flat-to-mid single-digit gains as rates begin to slowly rise





In late 2009, as we prepared our 2010 Outlook, we believed that following a solid start, a challenging second half of 2010 would unfold for investors. We anticipated the extraordinary global policy efforts that created tailwinds for markets in 2009 would fade, or even transition, to headwinds. These headwinds may contribute to a renewed slowdown in the economy and a potentially challenging latter half of 2010 for investors.

At the halfway point in the year, we take the opportunity to update and refine our outlook. We now believe some of the tailwinds we cited are likely to be with us for longer. For example, the Federal Reserve (Fed) is less likely to hike rates this year given the continuation of low inflation and the emerging concerns in Europe, leaving potent monetary stimulus intact. However, some of the headwinds we anticipated in the second half of the year have hit us sooner, such as China's slowdown fears. In addition, new headwinds have emerged and more may arise.

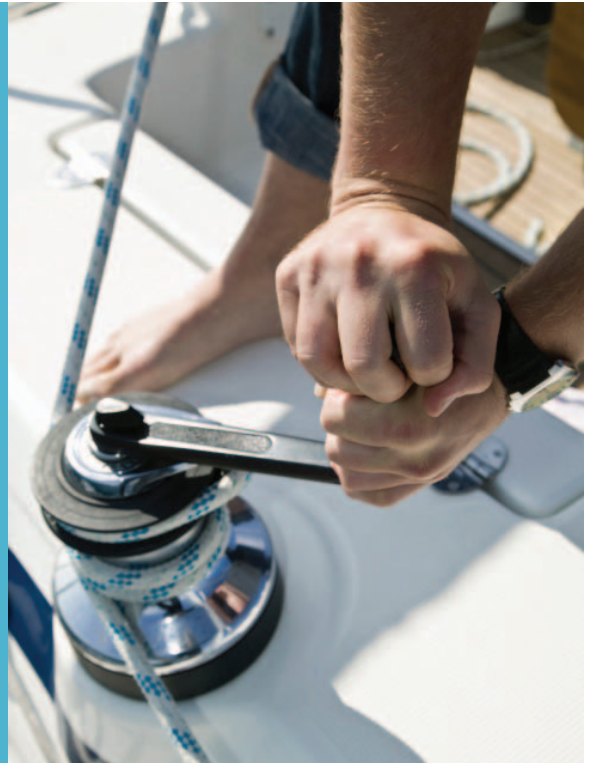
Tacking into the headwinds is necessary to advance against the wind when sailing. As with sailing, when investing, frequent adjustments may be necessary to stay on course. Volatility will remain elevated, presenting risks to be side-stepped as well as potential opportunities. Investors may benefit from a tactical approach to investing in the latter half of 2010 in order to find attractive opportunities when offered and successfully take profits when appropriate.

The economic forecasts set forth in this publication may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

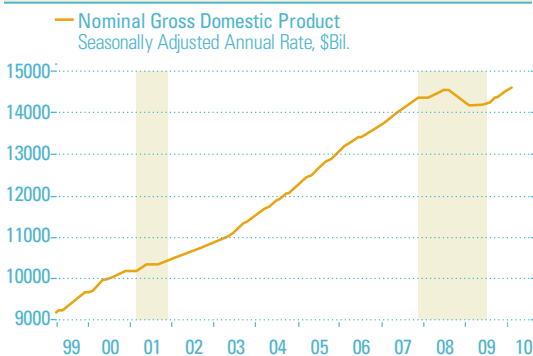


The Recovery Is Over, Welcome to the Expansion

The economic recovery in the United States that likely began in the summer of 2009 is ending as we enter the summer of 2010, but an economic expansion is now getting underway. Nominal Gross Domestic Product (GDP)—the broadest measure of economic activity in the United States—has already recovered all the ground it lost during the Great Recession of 2007–2009 and is now back above its prior peak. Put simply, the United States economy is now expanding, not just recovering. By comparison, it took the United States economy more than a decade to move past its 1929 peak during the Great Depression in the 1930s. In Japan, nominal GDP still has not surpassed its mid-1990s high. In the United States, we expect real GDP (GDP adjusted for changes in the prices of goods and services) to surpass its pre-recession high by the third quarter of 2010.



Gross Domestic Product Has Surpassed its Prior Peak Signaling the End of the Recovery Phase and the Beginning of the Expansion



Source: Bureau of Economic Analysis/Haver Analytics 06/21/10
(Shaded areas in chart indicate recessions)

While consumer spending, which accounts for more than 70% of GDP, and government spending have already surpassed their pre-recession peaks and are now firmly in recovery mode, not every area of the economy has recovered. For example, the United States economy shed nearly 8.5 million private sector jobs between December 2007 and December 2009. Through May 2010, the private sector of the economy has only added 500,000 jobs back.

Exports, business capital spending, housing construction, and spending on commercial real estate also remain below their pre-recession highs, but most if not all of these categories of spending are on track to surpass that important milestone in the coming months and quarters. For example, the return of global trade has led to a surge in U.S. exports since the end of the recession in the summer of 2009. The surge in exports in turn has led to a sharp rebound in business capital spending and inventory restocking.



This cycle may eventually lead to a more robust pickup in manufacturing employment, and the “virtuous circle” will take hold.

In our view, the recovery was the easy part. The United States (and other major countries) just had to provide enough stimulus—both fiscal (more government spending) and monetary (interest rate cuts and the purchase of debt by central banks)—to provide the initial boost. Virtually every major industrialized nation, along with many developing nations, including China, did just that in late 2008 and throughout 2009.

Today, near the midpoint of 2010, sustaining the recovery as the stimulus begins to fade is the hard part. Nominal GDP, nominal consumer spending, and other key indicators, such as the Institute of Supply Management’s (ISM) Purchasing Managers Index, are back to new highs. The pace of economic growth is likely to slow, and the two-steps-forward, one-step-back pattern of data points will contribute to volatility.

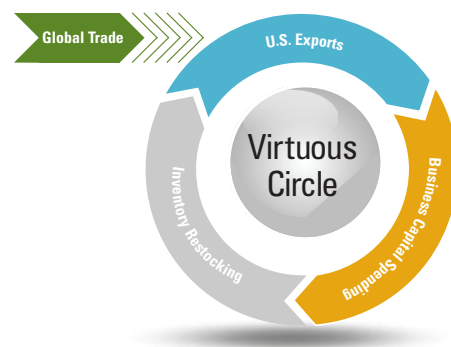
As is typical when making a transition from recovery to sustainable growth and expansion, the economy in mid-2010 faces several key obstacles—most notably the fiscal problems in Europe and the labor market in the United States. Over the past several months, the typical uncertainty in the path of economic growth, associated with the transition from recovery to sustainable growth, has been magnified by the flare-up of the fiscal problem in Europe and its potential impact on global economic growth. The United States’ banking system is relatively insulated from Europe’s debt woes. However, U.S. exports and business spending are vulnerable to two factors:

- A pullback in global growth that could result from a post Lehman-like freeze of global liquidity and trade
- A return to recession in the Eurozone as a result of cuts in government spending, tax increases, and higher borrowing costs

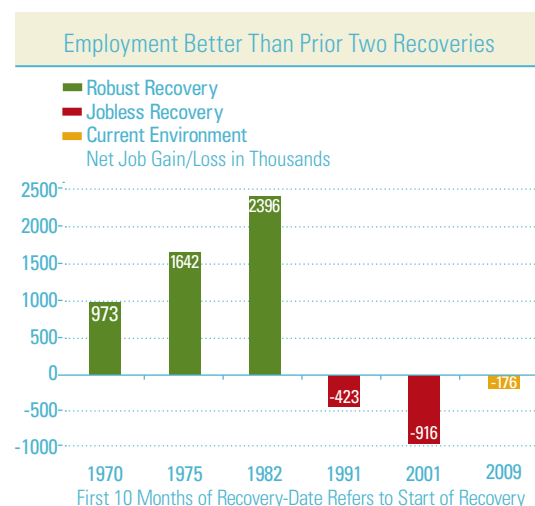
Through mid-June of 2010, we have yet to see any concrete evidence that the European fiscal and financial woes have spread to the rest of the globe, nor have we seen any evidence that any widespread damage has been done to the global financial system. The caveat, however, is that it may be too soon after the flare-up (late winter/early spring 2010) for the slowdown in Europe to have reached other countries. We will of course, continue to monitor this situation very closely in the coming months and make changes to our economic and market outlooks, if needed.

One of the other key areas we are watching in the early stages of this expansion is the labor market in the United States. While recoveries do not need job growth, an economic expansion cannot be sustained without it. Heading into 2010, our view was that the labor market would be more robust than in the “jobless recoveries” following the mild recessions in 1990-91 and 2001, but not as strong as the robust job recoveries following the severe recessions in the mid-1970s and early 1980s. Thus far, the data on the labor market through mid-June 2010 has supported that view.

After shedding almost 8.5 million jobs during the Great Recession, the U.S. economy has only added back about 500,000 private sector jobs over the first five months of 2010. The private sector has created jobs in six of the seven months starting with November 2009, the best performance for the labor market since mid-2007, prior to the onset of the Great Recession.

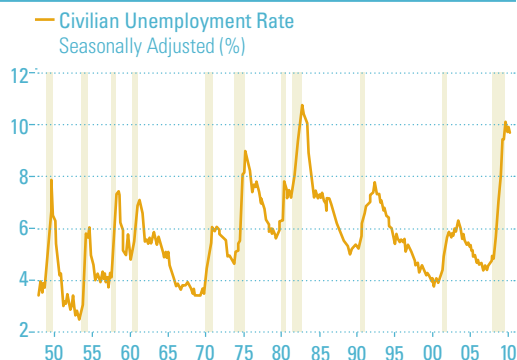


The pace of economic growth is likely to slow, and the two-steps-forward, one-step-back pattern of data points will contribute to volatility.



Source: Bloomberg; LPL Financial Research 06/15/10

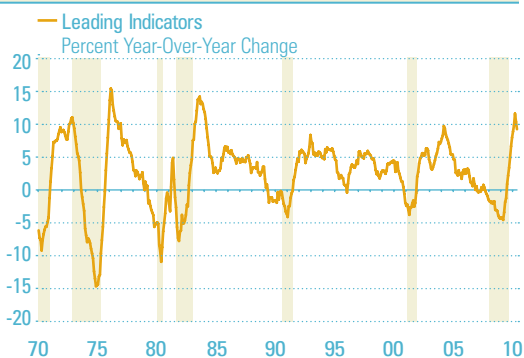
Unemployment Rate Remains Uncomfortably High and Is Likely to Decline Slowly



Source: Bureau of Labor Statistics/Haver Analytics 06/07/10
(Shaded areas in chart indicate recessions)

Based on leading indicators of the labor market, we believe that job growth is likely over the next 12 months, as the economy transitions from recovery to sustainable growth.

The Peak in Leading Indicators Often Ushers in Slower and More Volatile Economic Activity



Source: Bloomberg 06/18/10
(Shaded areas in chart indicate recessions)

The leading indicators of the labor market (hours worked, hiring of temporary workers, hiring of workers in cyclically sensitive industries like retail, transportation, and furniture manufacturing) point to further job gains in the months ahead. In addition, virtually every other employment indicator released as we approach mid-year 2010 (layoff announcements, initial fillings for unemployment insurance, hiring intention plans of corporations) continues to suggest that solid, but not spectacular, job growth is under way and will persist over the remainder of 2010. Based on these leading indicators of the labor market, we believe that job growth of around 200,000 to 250,000 per month is likely over the next 12 months as the economy transitions from recovery to sustainable growth. While not a robust jobs recovery, the job growth we forecast will be enough to drop the unemployment rate close to 9% by the end of 2010. As of May 2010, the unemployment rate stood at 9.7%.

Our concerns on the labor market looking ahead to the second half of 2010 (arranged from most likely to occur to least likely to occur) include:

- The best case is no hiring by state and local governments this year. But instead we may be looking at sizeable jobs losses in this sector, which accounts for about 15% of all employment.
- The oil-drilling moratorium in the Gulf of Mexico hurts oil and gas extraction employment. 166,000 people are employed in the oil and gas extraction sector according to the Bureau of Labor Statistics (out of an economy with 131 million jobs), but every little bit helps.
- Small businesses continue to hold back on hiring due to lack of credit and ongoing regulatory and legislative uncertainty.
- European economies falter, which dries up export-related jobs in the United States.

We will continue to watch the incoming data on employment, including but not limited to:

- Weekly jobless claims
- The regional ISM and Federal Reserve manufacturing surveys
- Layoff announcements tracked by Challenger
- The employment discussion in the Fed's Beige Book
- Hiring intention surveys
- Daily consumer confidence readings
- Inter-bank liquidity spreads
- A major slowdown in economic activity in Europe

For now, we remain confident in our forecast for 3–4% real Gross Domestic Product growth in the United States in 2010. The consensus outlook for U.S. GDP growth, at 3.2%, has moved much closer to our view in recent months. We continue to expect stronger GDP growth (3–5%) in the United States in the first half of 2010 will give way to a slowdown (2–3%) in the second half. However, a prolonged period of elevated global liquidity concerns and an outright return to recession in Europe, among other factors, would cause us to revisit our thesis on the U.S. economy for the rest of 2010.

European Contagion?



We have not materially altered our economic or market outlook in the face of the latest wave of financial stress focused in Europe. While we view the European debt problem as serious, we believe markets are taking an overly pessimistic view, including the prospect of a sovereign default, an event that is unlikely to be realized, in our opinion. Europe, with the help of the International Monetary Fund (IMF), has responded to the problem with a TARP-like bailout package, and several countries have announced fiscal belt-tightening measures intended to gradually reduce debt burdens.

Ultimately, we believe the U.S. will escape this contagion and the main consequence of the recent European events will be slower Eurozone economic growth. The spending cuts and tax hikes announced by Greece, Spain, and Portugal will likely tip their economies into recession, or, in the case of Greece, keep it there. However, so far no evidence has materialized indicating European debt problems have spread to other economies around the globe. In late May 2010, the Organization for Economic Cooperation and Development (OECD) increased its global economic growth forecast for 2010 and 2011. Stronger-than-expected growth in the U.S. and emerging market countries, despite sluggish European economic growth, was the main impetus for the upwardly revised forecast. China's exports boomed in May 2010, rising 48%, far exceeding consensus forecasts. If global consumption had been affected by Europe, a far weaker report would have likely been the result.

In the U.S., the bright spot of the economic recovery has been the export sector, and on that front, the prospect of slower European economic growth does not appear to have caused a derailment of the U.S. economic expansion. Exports comprise roughly 12% of U.S. economic growth, as measured by Gross Domestic Product, and Europe accounts for 20% of U.S. exports. The bulk, roughly 50% of U.S. exports, is consumed by faster-growing emerging market countries. Since exports contributed 0.82% to first quarter GDP growth, exports to Europe overall, and not just the 16 member countries that share the Euro currency, affected U.S. real

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Should European consumption of U.S. exports fall dramatically, the impact to the U.S. economy would likely be marginal.

GDP by 0.1% to 0.2%. Should European consumption of U.S. exports fall dramatically, the impact to the U.S. economy would likely be marginal.

With regard to financial markets, the European Union (EU) and IMF commitment of nearly \$1 trillion to support European sovereign debt markets enabling Greece and others to avoid having to raise money in the public markets if needed, should stabilize financial market confidence and liquidity. The package is aggressive in nature as the total dollar amount covers all the maturing bonds of the troubled Eurozone issuers—Spain, Portugal, Greece, Ireland, and Italy—for nearly three years. While European sovereign debt markets remain volatile, the EU support package provides an important funding backstop. The Fed's reopening of a US dollar swap credit line with the European Central Bank (ECB) should provide additional help. Following the 2008 financial crisis, the Fed's US dollar swap lines with the ECB proved instrumental in financial market improvement. The measures have had initial success and the 3-month LIBOR (London Interbank Offered Rate) has stabilized since late May 2010. Longer-dated 6- and 9-month LIBOR rates have declined notably from peak levels, indicating inter-bank lending fears have receded. Therefore, signs of bank funding strains remain modest.

Financial Leverage

In addition to funding strains, financial leverage is an important difference in the European debt problem versus the failure of Bear Stearns and Lehman Brothers in 2008.

- First, rather than a precursor to a renewed financial crisis, what Greece is experiencing is an aftershock of the financial crisis of 2008-09. The situation in Greece is akin to what many people and businesses that overindulged during the credit boom are now experiencing. Greece is feeling the negative consequences of the global recession as the downturn has forced Athens to tighten its belt to try to make ends meet while servicing its debt. This is typical of what happens at the end of a credit crisis and recession, rather than at the beginning.
- Second, the leverage tied to the problem is much lower. There is far less derivative exposure and financial leverage tied to European sovereign debt. Similar to many nations, Greece has debt roughly equal to 115% of GDP. This results in a 1.15-to-1.0 leverage ratio. When Bear Stearns and Lehman Brothers failed in 2008, they had about 40-to-1 leverage ratios, essentially multiplying the problem by a factor of 40. In addition, the assets the leverage is based upon are completely different. In Greece, the assets represent a diversified economy rather than lower-quality, mortgage-related assets as was the case for Bear Stearns and Lehman Brothers.

However, should a European financial institution fail as a result of a sovereign default, exposure to losses might be greater due to broader bank ties between U.S. and European banks. Such a sequence of events could change our investment view.

Sovereign Default

The European contagion could affect U.S. banks in the unlikely event of a sovereign default. Direct exposure to European sovereign debt among U.S. banks is very small at less than 0.5% or \$60 billion (as of June 20, 2010), according to estimates from Creditsights, an independent research firm. However, should a European financial institution fail as a result of a sovereign default, exposure to losses might be greater due to broader bank ties between U.S. and European banks. Such a sequence of events could



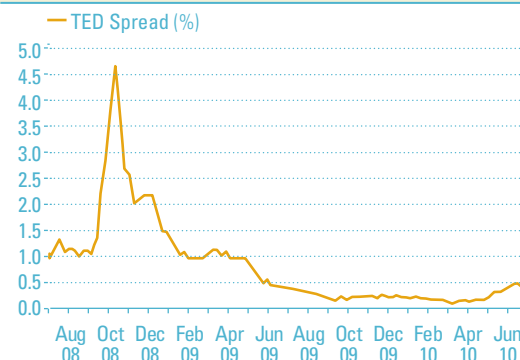
change our investment view. To monitor this risk we will be watching several indicators closely:

- **The TED spread.** The TED Spread (the difference between 3-month LIBOR and the 3-month T-bill yield) is a measure of stress in the banking system based on the willingness of banks to lend to each other and has risen this year to a slightly above the long-term average of 41 bps. While the TED spread has increased from a low of 15 bps, it remains well off of the crisis peak of 463 bps in 2008 and below the levels of 2008 that led up to the peak of the crisis in October 2008.
- **The level of European interest rates and credit default swaps (CDS).** Yields and CDS have both declined from recent peak levels. Should yields rise to double-digit levels or CDS increase to levels indicative of a distressed issuer, we would view this as the financial market's indication of a possible default or debt restructuring.
- **Corporate bond issuance.** New issuance, the lifeblood of healthy corporate bond markets, has contracted sharply, reflecting tighter financing conditions. Thankfully, most corporations have done an excellent job of refinancing near-term maturities and do not have a pressing need to access credit markets.
- **The use of central bank liquidity swaps and funding facilities.** Use remains light so far, but a significant increase would indicate financing pressures overseas.

Material deterioration would prompt us to re-evaluate our outlook and may warrant a more defensive investment stance.

In the meantime, investors may wish to consider the "silver lining" of European debt fallout. U.S. residential mortgage rates are back near the historic lows set in early 2009, with the average 30-year residential mortgage rate back under 5%. Fear over weak European demand has driven down gasoline prices as the summer driving season gets under way. Both of these effects put more cash in consumers' pockets. In addition, concerns over European growth will likely keep the Fed on hold for longer. Market expectations of the Fed's first rate hike have been pushed back to 2011.

TED Spread Remains Well Below Crisis Levels



Source: Bloomberg; LPL Financial Research 06/18/10

The market value of Corporate Bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.



The Headwinds Arise

In late 2009, as we prepared our 2010 Outlook, we believed that following a solid start, a challenging second half of 2010 for investors would unfold. We anticipated the extraordinary global policy efforts that created a tailwind for markets in 2009 would fade, or even transition, to headwinds that may contribute to a renewed slowdown in the economy and a potentially challenging latter half of 2010 for investors.



Distribution of the \$787 Billion in the American Recovery and Reinvestment Act of 2009

Category	Total Recovery Act Funds	Funds Paid Out	Percent Paid Out
Tax Benefits	\$288B	\$163B	57%
Contracts, Grants, Loans	\$275B	\$112B	41%
Entitlements	\$224B	\$131B	58%
Total	\$787B	\$406B	52%

Source: Recovery.gov 06/04/10

We now believe some of the tailwinds for growth are likely to be with us for longer:

- The Fed is less likely to hike rates this year, leaving potent monetary stimulus intact; this helps to sustain economic momentum.
- Other central banks may stall or slow their efforts to rein in monetary stimulus, resulting in ongoing stimulus at a time in the business cycle when it usually begins to fade.
- Commodity prices, particularly oil, fell sharply in May 2010. Oil retreated back to the levels of December 2009. The decline in prices is likely to translate into negative inflation readings for the second quarter and alleviate the typical upward pressure on commodity prices that can act to slow the pace of growth.
- Only about half of the \$787 billion American Recovery and Reinvestment Act funding has been paid out so far, leaving plenty of stimuli still in the pipeline. Adding to this is another spending package of nearly \$50 billion requested by the Obama administration to aid state and local governments in supporting the economic recovery.
- The environment for business is likely to be stronger for longer due to these lingering tailwinds. Given the constrained labor, tax, and interest expenses for businesses, profit margins are likely to be even wider than our initial forecast in the second half of the year. This has prompted us to raise our estimate for earnings in 2010 for S&P 500 companies from \$76 to \$80 for 2010, resulting in a 30% gain over 2009.



While the tailwinds for growth are likely to be with us for longer, headwinds are increasing. In fact, some of the headwinds we anticipated in the second half of 2010 have been pulled forward, as evidenced by China's economic slowdown, and new headwinds have emerged, such as Europe's debt troubles. These headwinds are more of a blow to confidence (valuation) than fundamentals (economic and profit growth).

The good news is that many of the headwinds are now priced into valuations for stocks, setting the market up for a potential rebound from the recent pullback. We also believe commodity asset class prices reflect these concerns. However, the bad news is that the rebound may be limited by more headwinds that may arise. The following headwinds are priced in to some degree and have pushed valuations back down to lows not seen since the end of March 2009, the month the market bottomed:

- Legislative uncertainty regarding taxes, financial regulatory reform, energy and climate change, among other initiatives with an impact on business, are keeping investors and business leaders cautious.
- The May 6 "flash crash," where stocks plunged and sharply rebounded 7% within an hour due to trading glitches, undermined confidence in the integrity of the markets.
- China's economy is beginning to respond to the efforts to slow its internal pace of growth and is risking slower export growth by floating its currency.
- As policy stimulus begins to fade in the United States, it is leaving behind the drag of a huge federal budget deficit that must be financed.
- While the EU and IMF rescue package combined with other measures addressed Europe's short-term liquidity problem, the long-term cost of austerity in the form of slower growth and the question of solvency linger.
- Economic indicators are peaking in the United States as economic momentum begins to slow. Leading indicators of economic activity, including the index of Leading Economic Indicators, Institute for Supply Management's Purchasing Managers Index, and the LPL Financial Current Conditions Index, have retreated from recent highs, suggesting the slowdown in economic momentum of the recovery.

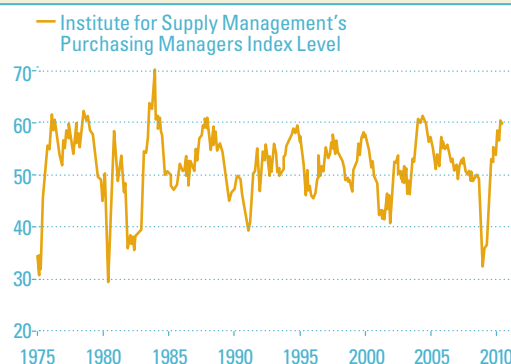
Treasury yields have priced in the above headwinds, as have commodity asset class prices. Stock market valuations also have discounted these concerns with the price-to-earnings ratio at 12 times the analyst consensus next 12-month earnings estimates. We expect the markets to rebound from the recent pullback, but also expect more volatility to follow rather than a return to the steep upward trend that defined most of 2010 through mid-April.

Of course, there may also be unforeseen headwinds that arise and affect the economy and markets. Some headwinds that do not appear to be priced in yet, and are likely to impact the markets at some point in the second half of 2010, include:

- The Fed beginning to hike interest rates sometime later this year or early next year.
- The risk of much higher energy prices if the Gulf of Mexico's oil supply is tightened due to regulatory measures, an above average storm season that disrupts production, or geopolitical events that disrupt deliveries.

The good news is that many of the headwinds are now priced into valuations for stocks, the bad news is that the rebound may be limited by more headwinds that may arise.

Leading Indicators Imply Momentum Beginning to Slow



Source: Bloomberg 06/01/10



- Geopolitical risk associated with a conflict on the Korean peninsula, the uncertainty surrounding the actions of an increasingly desperate Israel, the threat of a belligerent Iran, and Latin American instability.

The combination of lingering tailwinds and the onset of new headwinds have led to the return of volatility in the first half of the year, demonstrated by the S&P 500 moving in a band of about 1050–1225, oil prices ranging from about \$70 to \$85, and the yield of the 10-year Treasury note bouncing between 3–4%. While we expect the markets to end the year near the high end of these ranges, the markets may remain range-bound during the second half of the year as the headwinds keep a lid on the rallies.

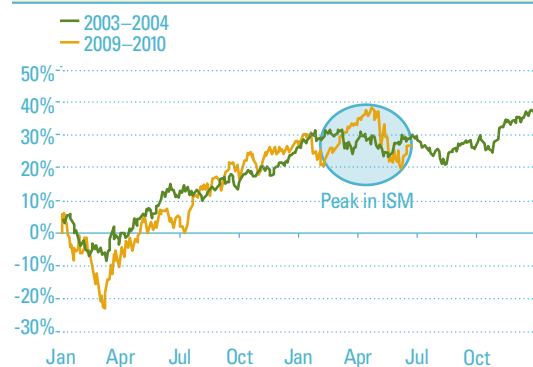
You Learn a Lot From the ISM Peak

Volatility is typical after leading indicators peak. One of the best leading indicators for the economy and markets is the Institute for Supply Management's Purchasing Managers Index. While the ISM has given a consistent signal when a recession is ending, it has also signaled when the recovery momentum peaks and the economy begins to transition to a new stage. Looking back at the ISM over the past 35 years, we can see that there have been a number of peaks and troughs that signaled the direction of economic and profit growth. The index has typically troughed around 30–40 and peaked around 60.

During the second quarter of 2010, the ISM rose to 60 signaling a peak in economic momentum. The S&P 500 has tended to perform very well during the year leading up to the peak in the ISM. Over the past 35 years, the S&P 500 was up 18%, on average, in the 12 months prior to the peak in the ISM. However, once reaching the peak, returns were flat and volatile. During the six months following the peak, stocks were up only 1%, on average.

With the ISM peaking, it is no surprise that stock market performance momentum has recently stalled and become range-bound and volatile. The last time the ISM peaked after a recovery was in 2004, which provides a good example of what may take place in the stock market in 2010. In the nearby chart, it is easy to see how the stock market momentum stalled in 2004 about a year after the bottoming of the ISM and the S&P 500 became more volatile and range-bound.

ISM Peak Signals Flat Returns and Volatility
S&P 500 Performance in 2003–2004 and 2009–2010



Source: LPL Financial, Bloomberg 06/18/10

The S&P 500 is an unmanaged index which cannot be invested into directly. Past performance is no guarantee or future results.

ISM Peaks

	S&P 500 Price Change	
	12 Months Before Peak in ISM	6 Months After Peak in ISM
Feb. 1976	22.20%	3.20%
Jul. 1978	1.85%	-0.70%
Nov. 1980	32.40%	-5.60%
Dec. 1983	17.30%	-7.10%
Oct. 1987	3.20%	3.80%
Oct. 1994	1.00%	9.00%
Jul. 1997	49.10%	2.70%
Nov. 1999	19.40%	2.30%
May 2004	16.30%	4.70%
Average	18.10%	1.30%

Source: LPL Financial 06/18/10



How to Potentially Profit and Protect in the Headwinds



Tacking into headwinds and navigating tricky cross currents are necessary to advance against the wind when sailing. The same is true in investing when frequent adjustments may be necessary to stay on course, especially in markets demonstrating elevated volatility. Investors may benefit from a tactical approach to investing in the latter half of 2010, in order to take advantage of attractive opportunities and successfully take profits when appropriate.

As the economy transitions from recovery to sustainable growth, we expect an economic expansion that will feature uneven economic data, evolving market leadership, and elevated levels of market volatility. The difficulty with investing in markets that are in flux is that they are moved by both positive and negative factors—often at the same time. As a result, transitioning markets often display fairly range-bound returns but are also characterized by heightened volatility. With a focus on opportunistic investing, LPL Financial Research attempts to position portfolios to become aggressive when volatility presents opportunity, but profit defensively when market volatility suggests danger.

To thrive in the transitioning markets we expect in the second half of 2010, several considerations may contribute to help investment success, including focusing on yield, finding opportunities in the face of headwinds, seeking benefits from the elevated volatility, and utilizing a more active rebalancing approach.

Focusing on Yield

In an environment where volatility is the primary characteristic, LPL Financial Research prefers strategies that focus on the income stream of an investment rather than solely on potential price appreciation to generate total returns. We believe a higher yield may benefit portfolios by providing a consistent income component that is received regardless of price movements, cushioning downward market moves.



There are several ways to help benefit from a focus on yield:

- **High-Yield Bonds:** Our favorite way to increase yield remains the High-Yield Bond asset class. In addition to offering a solid yield, this asset class benefits from contracting yield spreads and improving financial conditions of underlying issuers.
- **Real Estate Investment Trusts (REITs):** In addition to offering a considerable yield that should help cushion portfolios from unexpected market volatility, REITs possess stable fundamentals that may benefit from economic growth and a further increase in employment. REIT fundamentals tend to recover later in the economic recovery/expansion cycle than most other industries, suggesting more improvement to come. Also, given their low correlation to other income-generating investments, REITs have historically been able to help improve portfolio diversification—also a benefit in periods of volatility.
- **Emerging Market Bonds:** Investing in Emerging Market Bonds offers exposure to fast-growing emerging market economies with less risk than investing directly in Emerging Market Equity. For example, relative to the difficulty experienced in the 1990s, credit conditions in emerging market nations have improved dramatically. Most notably, this is reflected in improved credit ratings and lower borrowing costs. In addition, Emerging Market Bonds tend to offer solid income opportunities, especially compared to other high-quality government debt.
- **Dividend Paying Stocks:** With investment returns likely muted during the second half of 2010, dividends may be the difference between market-beating and market-lagging results. Over the last few years, substantial numbers of companies have reduced or discontinued paying dividends due to the concerns over survivability through the recent Great Recession. However, with profits for companies back to, and in many cases above, pre-crisis levels, look for an emerging theme in the form of increasing or newly established dividends.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Stock investing may involve risk including loss of principal.

Bank Loan portfolios primarily invest in floating-rate bank loans instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London Interbank Offered Rate, or LIBOR.

Municipal bonds are subject to availability, price and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Small Cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the Small Cap market may adversely affect the value of these investments.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Finding Opportunities in the Face of the Headwinds

With the emerging headwinds on the rise, one attractive strategy for portfolio success is to find investments that tend to benefit when many other investment vehicles struggle. This includes finding strategies that may thrive in periods of potentially rising inflation rates, increasing tax rates, and the shift to restrictive monetary policies.

- **Bank Loans:** One likely headwind that will face the market in late 2010 or early 2011 is the steady increase in rates. This scenario will hurt most high-quality bond sectors. However, the Bank Loan asset class normally benefits in such periods as its adjustable rate feature actually resets to higher yields, which could improve return opportunities.
- **Commodities Asset Class:** In addition to the fact that these investments offer attractive opportunities given the recent fears of a global-growth slowdown and Eurozone contagion, Commodity asset classes benefit from rising inflation, another potential headwind, and soaring price increases. Additionally, Commodity asset classes stand to benefit from the global economic recovery, especially in China and the surrounding region, and offer potential hedges against a weakening US dollar.



- **Municipal Bonds:** Given the likely political pressure for higher taxes to pay for soaring government debt, municipal bonds offer attractive yields, especially on an after-tax basis.
- **Small Cap Equity:** With the likely continuation of the headwinds created by slowing growth in Europe, smaller cap companies could be relative return winners since they are more domestically-focused, and they could be better insulated if a contagion develops. We continue to believe the U.S. economy will remain more robust and consistent than the rest of the developed world, especially compared to Europe. Since small cap companies have more domestic sales exposure than their large cap peers, they have greater leverage to increasing demand in the U.S. economy.

Seeking Benefits From the Elevated Volatility

With volatility on the rise, finding investments that may benefit from heightened uncertainty helps not only to potentially improve returns, but also reduce portfolio risk.

- **Alternative Strategies:** To help with increased volatility, alternative strategies, including Global Macro and investment vehicles exposed to Long/Short and Covered Calls may be potential sources of diversification and some risk reduction. The side bar describes some alternative strategies that we believe you should consider in a volatile environment.
- **Large Blend Equity:** In a market environment characterized by modest gains and increased levels of volatility, Large Blend equities can offer a solid yield and less cyclical exposure of predominately blue chip names. Both of these defensive characteristics are attractive as they may provide added insulation from unexpected market swings while participating in market advances.

Utilize a More Active Rebalancing Approach

In a market that is shifting, producing multiple pullbacks but remaining largely range-bound, one strategy is to “buy the dips and trim the rips.” We believe that a more active rebalancing strategy that employs a tactical approach to investing may enhance performance during these periods by positioning portfolios to become aggressive when volatility presents opportunity, but may profit defensively when market volatility suggests danger.

- **Opportunistic Equity and Balanced Strategies:** One way to try and benefit from greater tactical opportunities without the need to conduct frequent asset allocation changes is to implement shifts with balanced strategies that opportunistically move from fixed income to equities, Commodity asset classes to sectors, and everywhere else in between to help take advantage of the most attractive investment opportunities.

Alternative Strategies

Covered Call strategies purchase securities and then sell calls against them to generate income and provide some downside protection. Because volatility is a component of pricing, these strategies tend to benefit in more volatile market environments.

Managed Futures strategies take long and short positions in futures contracts, government securities, and options on futures contracts. Managed futures tend to use technical analysis in most of their management practices.

Global Macro strategies profit from global mispricings and trends across various markets. In a volatile environment, these strategies may find more mispricings and therefore possible investment opportunities.

Long/Short strategies hold stocks long and short other stocks to hedge the original investment. Unlike traditional long strategies, the ability to short stocks allows these portfolios to find possible opportunities during weak markets.

Absolute Return strategies strive to generate a positive return in any market at any time. The investment’s return is not evaluated relative to a specific index or the market’s performance.

Market Neutral strategies seek to create a portfolio not correlated to overall market movements and insulated from systemic market risk.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor’s portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses, such as losing the entire amount paid for the option.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

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This information is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. We suggest that you discuss specific tax issues with a qualified tax advisor.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Investing in alternative investments may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potentially illiquidity. There is no assurance that the investment objective will be attained.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

ISM Manufacturing Index: An index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Challenger, Gray & Christmas is the oldest executive outplacement firm in the United States. The firm conducts regular surveys and issues reports on the state of the economy, employment, job-seeking, layoffs, and executive compensation.

TARP: Troubled Asset Relief Program is a program of the United States government to purchase assets and equity from financial institutions to strengthen its financial sector. It is the largest component of the government's measures in 2008 to address the subprime mortgage crisis.

London Interbank Offered Rate (LIBOR): An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

Leverage Ratio: By using a combination of assets, debt, equity, and interest payments, leverage ratios are used to understand a company's ability to meet its long-term financial obligations. The three most widely used leverage ratios are the debt ratio, debt to equity ratio, and interest coverage ratio. The debt ratio gives an indication of a company's total liabilities in relation to their total assets. The higher the ratio, the more leverage the company is using and the more risk it is assuming.

The P/E ratio (price-to-earnings ratio) of a stock (also called its "P/E", or simply "multiple") is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Low correlation means that different asset types have not performed in the same way: When returns on some asset types were declining, returns on others were gaining.

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