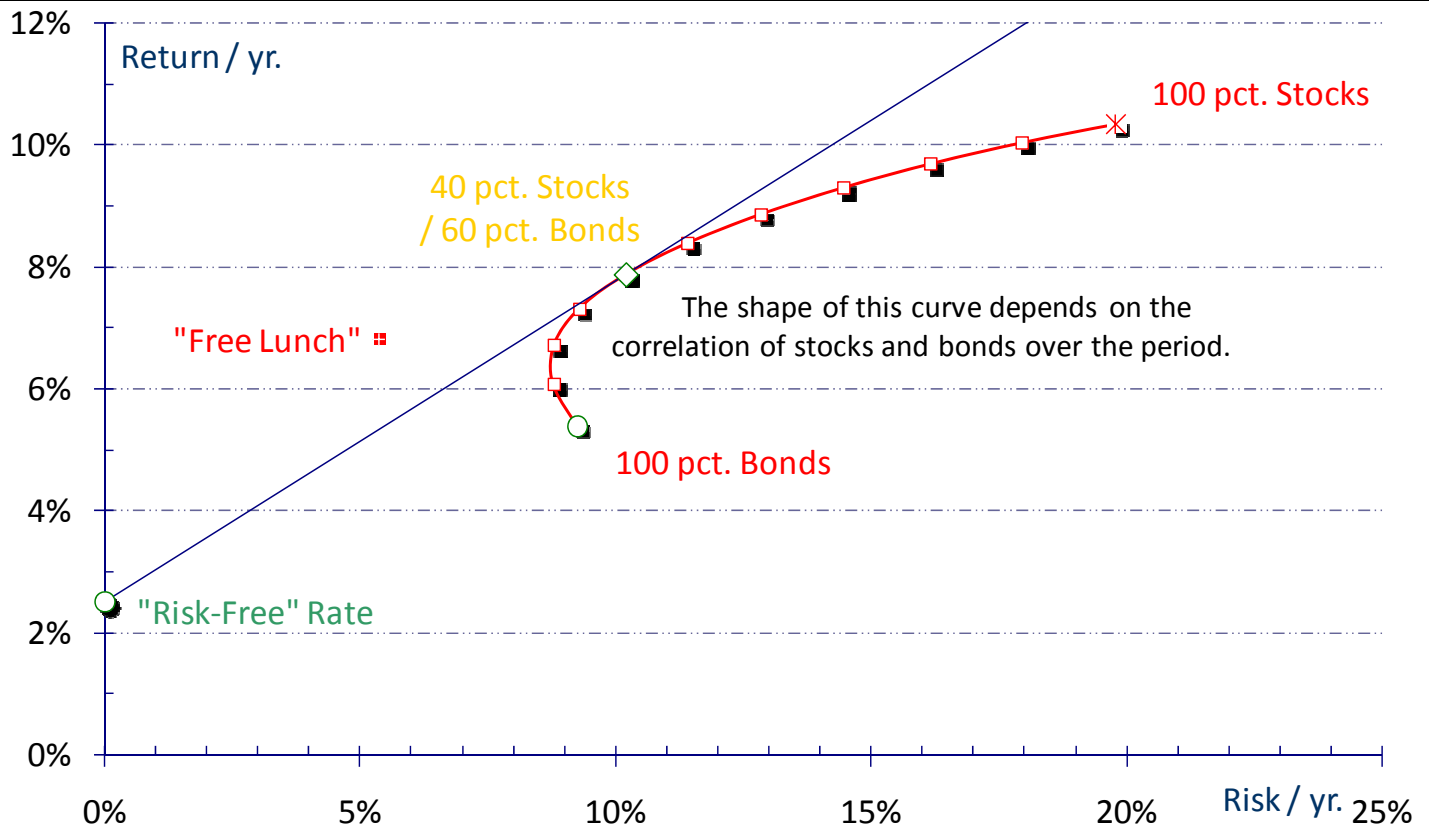


Bearish BARRON'S Roundtable is Probably a Bullish Sign

- Investment outlook season is here again; not only have we prepared our own edition for your review, we also like to survey the scene. Because the New Year is the time when numerous insightful observers are willing to gaze into the future to anticipate changes in the investment landscape, it gives us all an opportunity to reflect. We like to compare and contrast our own thinking with as many others as possible, to see how we may differ from the consensus. BARRON'S roundtable this week makes us more comfortable with our own constructive market view.
- Many of us would like to think of ourselves as "contrarians," i.e. investors who often march to a different drummer. Perhaps contrarians should be known as the "mavericks" of the market. Some refused to ride the technology bull market, pushed hard against it, and made a fortune when it collapsed. Others constructed a bearish case against the housing market and its beneficiaries a few years ago — and may have lost a bundle anyway, by underestimating the breadth or the severity of the resulting crash.
- Surviving as a market maverick is just practicing plain common sense. There are only a few steadfast rules; such as that there is no such thing as a free lunch. If something seems too good to be true, it probably is. When too many people are moving to one side of the boat, it is often wise to seek a good spot on the other side ... or look for another boat.
- However, it is important to note that — in investing — the consensus view is not always wrong. In fact — based on the same principles as we use in our elective or judicial processes, it is often correct. Finding an interpretation that seems reasonable to most — or some kind of a compromise between more extreme views — cannot be a bad path to take, can it? Even so, it may still be wise to purposely seek out some investments that are not supported by the consensus view.
- If the consensus is often correct, why is there so much focus on investment surprises at this time of year? Probably because the consensus view is already imbedded in market prices. When the consensus proves to be correct, you get a decent but unexciting return. But the returns associated with unexpected outcomes are likely to be significantly higher or lower than what you might achieve if you go with the consensus and you are right.
- In BARRON'S this week, the annual roundtable was as bearish as we can remember reading it. Only one participant professed a bullish stance, and the best he could say was "the stock market is probably the place to be, particularly financials." A few claimed that this is a "stock-picker's market," meaning they do not expect much at all from the broad averages. Echoing the theme, a well-known Wall Street strategist said the indiscriminate sell-off had created "a real disequilibrium within individual asset categories ... giving careful investors an opportunity."
- We agree with that view, and also that "fair value for the S&P 500 is somewhat above where the market stands today." We are mainly surprised that there was virtually no real optimism exhibited. One participant admitted he had bought some U.S. stocks for the first time in 30 years; we will wait for a future edition to see what he likes. We like large-cap, high quality stable growth stocks, which are attractively valued as compared to their own debt securities.
- One important lesson from the roundtable is to search for the best way to express your market views. Last year, one participant was prescient in his dislike for the Chinese equity market and other emerging markets. Many of these markets lost -50% or more, but some of the securities he thought would benefit from the decline were a disappointment. Some securities appear to be efficient for traders only; longer-term holders may not achieve their desired results, even if their investment thesis winds up being correct.

History and Theory Show How a Diversified, Rebalanced Portfolio Can Have Lower Risk



Note: Based on historical data of the S&P 500 and long-term Treasury bonds from 1926-2008. Endpoints of curved line represent annualized risk and return of fixed portfolios (100% stock and 100% bonds). Points on the curve represent annually rebalanced portfolios: 10% stock + 90% bonds; 20% stock + 80% bonds; 30% stock + 70% bonds; 40% stock + 60% bonds, etc. Past performance is not a guarantee of future results. Source: Federal Reserve, Morningstar, Standard & Poor's.

The chart above is a simple but real example of how diversification has worked to investors' benefit over time. The endpoints of the curved line show what a "buy-and-hold" investor might have achieved (in terms of annualized return and risk) in the S&P 500 or in long-term government bonds from 1926-2008. Each point (square box) in between illustrates the risk/return of a portfolio representing some stock and the remainder in bonds, "re-balanced" each year. Note how the square boxes are *not* on a straight line between 100% stock and 100% bonds. Instead, they reside on a curve, bending toward the left. The curve shows the power of diversification; usually, the result has been less risk per unit of return.

This chart shows the value of diversifying between just two assets, US stocks and bonds. The straight line represents the "frontier," or edge, of what many assume is achievable. We have labeled a point "free lunch," because it represents a portfolio that is theoretically improbable. Not impossible, but probably not achievable over any long period. Today, we design diversified portfolios with 10-15 assets or more, but the basic theory is the same. Over time, investors have learned one lesson well: portfolio rebalancing usually proved helpful.

Tom McManus

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Additional Information Available Upon Request

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