

# The Week



May 18, 2009

Tom McManus, Chief Investment Officer

## Capital Market Assumptions Update

### Executive Summary

#### Methodology

As with virtually every aspect of financial market analysis, judgment must be applied in developing the assumptions for capital market returns, risk and correlation (CMAs). In developing this periodic review of the CMAs, we examined the prior framework in the context of what we believe are best practices in the industry. We agree with the basic concept of "mean reversion" underlying the prior methodology (known as "Price Matters"). We also believe some of the markets may have been too optimistic about the sustainability of the underlying trends leading up to the recent economic peak in 2007.

It is important to know and understand where we've been, but it is equally important to have a forecast of where we're going. Economic growth is the key driver of corporate profitability and earnings. This has a direct impact on returns for specific asset classes and many key interrelationships. These correlations, risks and returns are the capital market assumptions that drive the investment advice that shapes our strategic asset allocation models. It is important to note that while we make the case for certain biases between asset classes, proper diversification is the key driver of a portfolio's long-term performance.

**Our CMAs and strategic asset allocations are 10-year forward-looking assumptions.** The steep declines in many asset classes seen since 2006 have shaken the faith of many investors. In many cases, the associated losses were so far outside the range of expectations that we believe it is worthwhile for us to reexamine the basic elements — the fundamentals — of growth for production, earnings and wealth in our economy. For the purpose of our longer-term projections for capital market risk and returns, we assume that the economic trend will bottom in late 2009 and 2010 will be a year of modest recovery. In our view, economic growth will recover slowly at first and then pick up steam.

We expect the underlying trend growth rate for GDP to be +4.8% per year, about -0.4% less than we have experienced in the past 15 years. Consumers' urge to borrow and spend eventually hit a wall with the housing-related economic and financial crisis that we are suffering through now. But as we look forward to set our CMAs, we make two important observations: 1) the era of consumerism helped fuel growth in the economy — and thus revenues and profits for many companies — above and beyond what would have been seen otherwise; and 2) given the hangover we are suffering now, it is highly unlikely that we will attend a similar party soon. Therefore, we anticipate slow growth for the economy and stock averages over the next 10 years, as the economy reconfigures itself to be less dependent on the extravagant urges of the U.S. consumer. We doubt that real growth in the economy will be strong enough to require the Federal Reserve to raise the fed funds rate before late 2011 or 2012.

**Inflation:** The outlook for inflation is a critical variable in portfolio construction, as it helps determine the relative attractiveness of various asset classes under consideration. Over many years, the compounding effect of the inflation rate will play a major role in investors' ability to meet their goals. We suggest that investors project long-term liabilities using an average inflation assumption of 2.5%. If we are correct in expecting economic recovery to begin in the latter part of 2009 and continue into 2010, then downward price pressures should eventually reverse again to the upside. Our current problems — the near-term effects of the housing and financial crisis — are exerting downward pressure on prices. But we believe the solutions — the monetary, regulatory and fiscal responses to the crisis — are inherently inflationary. Given the immense fiscal stimulus programs in the U.S. and around the world, and the dramatic increase in the size of the Fed's balance sheet, a recovery may stoke inflationary fears sooner — and perhaps with more vigor — than in previous cycles. If the rate of inflation should rise meaningfully, it would probably have a positive impact on earnings prospects and credit spreads, potentially helping corporate bonds (especially high yield) and equities (especially highly-levered companies) at the expense of more conservative investments like Treasury bonds and shares of cash-rich companies.

## A Review of Selected Asset Classes

**Large-Capitalization Equity:** Our return expectations are higher than before, but we anticipate slow growth for the economy and stock averages over the next 10 years, as the economy reconfigures itself to be less dependent on the extravagant urges of the U.S. consumer. Investors interested in a “re-entry point” into stocks (and those who never left) should consider our 10-year target price of 1700 for the S&P 500 index. From the six-month average level of 850, this implies an average capital gain projection of +7.2% per year. With dividends, total returns would approach +10% per year with average annual volatility of 20.3%.

**Small- and Mid-Capitalization Equity:** For small-capitalization stocks we project nominal total returns of +10.5% per year (volatility = 25%/year), and +10.3% per year for the mid-capitalization sector (volatility = 24%/year). History shows that smaller companies typically outperform in the early stages of an economic recovery, and we expect that to recur in the next recovery, but to a smaller degree. Over the long term, our data indicate that returns of small-caps are not sufficiently different — over 28 years of actual performance — to conclude that smaller companies provide investors with significantly higher returns. Despite the lack of evidence supporting the long-term outperformance of smaller companies (especially when their higher risk is taken into account), we believe investors should consider an allocation to smaller companies for the potential to participate in their projected return and diversifying benefits.

**Growth and Value Investment Styles:** We believe growth stocks will outperform value stocks with lower volatility. Our projections call for growth stocks in each capitalization range to outperform value stocks by a small amount — about +0.5% per year — over the next 5–10 years. Outperformance of this magnitude will not be a surprise if the economic growth trend is slower than that of the past 10–25 years. Growth companies, in general, are better capitalized and can finance their own growth without incurring debt — so they are less reliant on the economic cycle to produce earnings than their value counterparts. The difference between value and growth is wider for the large-capitalization companies than for the smaller ones, because public debt markets have been more accessible to the larger enterprises.

Perhaps more controversial is our belief that growth stocks will also be slightly less volatile than their value counterparts. In the past, value stocks have tended to be less volatile than average, largely because more of their total return was delivered in the form of seemingly reliable dividends. What investors are being reminded in 2008-09 is that dividends are by no means guaranteed, particularly in the value space, as the deterioration in the credit markets and subsequent deleveraging has forced more cyclical companies to preserve capital by slashing dividends.

**International Equities:** Our expected annualized return forecast for the International Equity class is 9% — a little lower than domestic large-cap stocks — because of the severity of the economic slowdown in Europe and continued stagnation in Japan. The volatility forecast is 24%, significantly higher than the 20.3% we are assuming for the domestic equivalent. Dollar weakness has been a consistent — if not steady — trend over the past 40+ years, and we expect this trend to continue. That weakness helps boost the return in dollars for investors in international stocks, just as it helps U.S. companies with substantial international operations. We believe this effect will be responsible for almost one-tenth of international stocks’ return.

**Emerging Market Equities:** For emerging market stocks, we are assuming an incremental +2% per year above developed international stocks, or 11% total return. We are concerned that much of the growth of the emerging markets has depended on providing discretionary products to consumers in developed markets like the U.S. and Europe, and that the financial crisis has undermined that demand. Eventually, these developing countries should generate a significant increase in domestic consumption and thus be less dependent on the unsustainable demand from areas like the U.S. If they generate enough demand domestically, their economies and capital markets should produce a higher return than the 11% we project. Our volatility assumption for emerging market equity is 29%, well above the 24% we project for developed international markets.

**Fixed Income:** The starting point matters, so we are lowering expected returns for fixed-income instruments. Most of the nominal long-term total return for bond investors can be explained by the initial yields at which they are invested. Instead of simply using a representative benchmark Treasury yield (short, intermediate, and long) in deriving our current fixed-income capital market assumptions, we used a blended benchmark of Treasuries, government-related debentures and corporate bonds that we believe are more representative of what investors hold. At the intermediate maturity horizon (7–10 years), we expect returns of 4.3% for Taxable Fixed Income and 3.4% for Tax Exempt Fixed Income, with projected risk of 4.5% and 6.8% respectively.

The credit market disruptions and recessionary environment of the past 12 to 18 months have led to large yield differentials between low-risk bonds and risky bonds. We expect that differential to become less extreme over time. We relied largely on starting nominal yields, and then looked at historical relationships between different points on the yield

**See pages 4-6 for Important Information and Disclaimers.**

curve as well as yield differentials between Treasuries and other types of bonds. For each credit sector we also degraded expected cash flows for defaults and recovery rates. The result is a reduction in the expected returns, which is consistent with the fact that benchmark Treasury yields are at or near secular (long-term) lows.

**High Yield:** It is our view that the easy credit cycle of the early part of this decade has generally weakened the credit quality of the high-yield market. Projected rates of default (above historical averages) and recovery (below historical averages) suggest that high-yield returns should be well below both the stated starting yield (15%) and the historical discount of 2% to 3% from that starting yield. Our return assumptions use a combination of projected default and recovery rates from the major ratings agencies as well as market-based indicators such as credit default swaps for baskets of high-yield bonds.

**REITs:** Despite the terrible recent performance of the Real Estate Investment Trust category, this asset class is only marginally attractive. Our expected average annualized return for the broad class of equity REITs is 7.8%, with volatility of 16% per year. It is too soon to say that conditions in the sector are improving, but the valuations have become more attractive. Many of the companies have been able to raise some equity and are taking early steps to manage their upcoming debt maturities. Therefore, we have reduced our underweighting in REITs.

**Commodities:** The historical total return of commodities has been comparable to the returns on stocks, but with significant diversification benefits relative to a portfolio of solely stocks and bonds. In the investable commodities arena, we project annual total returns averaging +8.0% with annualized volatility of 24%. This return represents a +5.5% risk premium above our +2.5% inflation assumption, which is only a little higher than the average historical risk premium that an investor might have achieved over the long term.<sup>1</sup>

## Implications for Our Strategic Asset Allocation Models

The lesson learned over time — and supported by theory — is that simple combinations of stocks and bonds, if rebalanced periodically, have tended to provide more return per unit of risk than one might expect by simply averaging the statistics of the separate asset classes. There's no guarantee that this will always work, but it is for this reason, in addition to our forward-looking assumptions, appropriate diversification is a key factor in developing our strategic asset allocation models. The primary difference among models is the allocation among major asset classes such as a) Traditional Fixed Income; b) Alternative Income; c) Equities; and d) Other Alternatives.

The most significant feature of our strategic models is a bias toward growth in the equity portion of the portfolios because good growth companies are attractively valued after the sharp market decline. Our bias toward growth is more pronounced among larger-capitalization companies than among small- or mid-caps. As we expect the economy to improve through 2010, our view that large-cap stocks will lead the way has caused us to shift a bit toward large-caps versus mid- and small-caps.

Our Income and Growth & Income models — and even our Growth models to some extent — previously had a bias toward value equities, largely because of a significant dividend content advantage. This advantage is less important now as the market decline has raised the dividend yields of growth companies, and as many companies in the value realm have been steering cash away from dividends and toward more pressing needs. In general, our Income models have added equity exposure to provide diversification and take advantage of stocks' potentially higher returns.

Our focus toward growth opportunities is also reflected in a slight shift in our international equity exposure toward emerging markets and away from developed markets. Despite the recent strength of the dollar as compared to its long-term downward trend, we believe U.S.-based investors are still well-advised to consider non-dollar-denominated opportunities, and the intermediate to longer-term outlook for emerging markets is still positive, in our view.

The forward-looking CMAs and models presented here represent our best estimates as of March 2009 and will change with time. Wells Fargo Advisors will be happy to provide updates on request.

**See pages 4-6 for Important Information and Disclaimers.**

---

<sup>1</sup> Gorton, Gary B. and Rouwenhorst, K. Geert, "Facts and Fantasies about Commodity Futures" (February 28, 2005). Yale ICF Working Paper No. 04-20. Available at SSRN: <http://ssrn.com/abstract=560042>. The information is for the periods 1959 through 2004. Authors updated the information through 2007 and it was further updated by Wells Fargo Advisors through April 2009.

Capital Market Assumptions, March 2009 (10-Year Horizon)					
Number	Asset Class Name	Geometric Return <sup>1</sup>	Risk <sup>2</sup>	Yield <sup>3</sup>	Downside Risk <sup>4</sup>
1	Cash Equivalent	3.0%	1.0%	3.0%	1.4%
2	Short Term Taxable Fixed Income	3.8	2.5	3.8	-0.3
3	Intermediate Taxable Fixed Income	4.3	4.5	4.3	-2.9
4	Long Term Taxable Fixed Income	4.8	8.5	4.8	-8.3
5	Short Term Tax Exempt Fixed Income	3.0	3.5	3.0	-2.6
6	Intermediate Tax Exempt Fixed Income	3.4	6.8	3.4	-7.2
7	Long Term Tax Exempt Fixed Income	4.3	9.0	4.3	-9.5
8	International Fixed Income	5.3	7.0	5.3	-5.6
9	High Yield Fixed Income	8.8	16.0	8.8	-14.3
10	Emerging Market Debt	8.3	14.5	8.3	-12.9
11	REIT Equity	7.8	16.0	8.0	-15.3
12	REIT Mortgage	8.5	26.0	11.0	-25.7
13	Large Cap Blend	10.0	20.3	2.7	-18.1
14	Large Cap Growth	10.3	20.0	1.8	-17.6
15	Large Cap Value	9.8	20.5	3.5	-18.7
16	Mid Cap Blend	10.3	24.0	1.3	-22.0
17	Mid Cap Growth	10.5	23.8	0.7	-21.5
18	Mid Cap Value	10.0	24.3	1.8	-22.5
19	Small Cap Blend	10.5	25.0	1.2	-22.8
20	Small Cap Growth	10.8	24.8	0.6	-22.3
21	Small Cap Value	10.3	25.3	1.7	-23.3
22	International Equity	9.0	24.0	2.8	-23.2
23	Emerging Market Equity	11.0	29.0	1.8	-26.3
24	Multi Class (60% #13, 40% #3)	7.7	11.5	3.3	-9.6
25	Managed Futures	7.0	14.0	0.0	-13.5
26	Commodities	8.0	24.0	0.0	-24.1
27	Gold	6.5	14.0	0.0	-14.0
28	Hedge Funds - Relative Value	6.5	15.0	0.0	-15.2
29	Hedge Funds - Diversified	7.3	14.0	0.0	-13.2
30	Hedge Funds - Hedged Equities	7.8	13.0	0.0	-11.5
31	Other	3.7	25.0	0.0	-29.2
1) Compound annual growth rate. 2) Annual standard deviation. 3) Average annual. 4) The return threshold below which one would expect returns to fall only once in 20 years (5% probability).  * Standard deviation measures the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation.  Source: Wells Fargo Advisors.					

## Important Information and Disclaimers

**Wachovia Securities (Wachovia Securities, LLC and Wachovia Securities Financial Network, LLC) is now Wells Fargo Advisors.**

Past performance is not a guarantee of future results.

Technical analysis is based on the study of historical price movements and past trend patterns.

Diversification does not guarantee a profit or protect against loss.

High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds.

Bond prices fluctuate inversely to changes in interest-rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

The prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.

There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions. Distributions from REIT investments are taxed at the owner's tax bracket.

Buying commodities allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

Hedge funds are complex, speculative investment vehicles and are not suitable for all investors. They are generally open to qualified investors only and carry high costs, substantial risks, and may be highly volatile. There is often limited (or even non-existent) liquidity and a lack of transparency regarding the underlying assets. They do not represent a complete investment program. The investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Hedge funds are not required to provide investors with periodic pricing or valuation and are not subject to the same regulatory requirements as mutual funds. Investing in hedge funds may also involve tax consequences. Speak to your tax advisor before investing. Investors in funds of hedge funds will incur asset-based fees and expenses at the fund level and indirect fees, expenses and asset-based compensation of investment funds in which these funds invest. An investment in a hedge fund involves the risks inherent in an investment in securities, as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-U.S. securities, "junk" bonds and illiquid investments. There can be no assurances that a manager's strategy (hedging or otherwise) will be successful or that a manager will use these strategies with respect to all or any portion of a portfolio. Please carefully review the Private Placement Memorandum or other offering documents for complete information regarding terms, including all applicable fees, as well as other factors you should consider before investing.

**Indexes Mentioned:**

**Large-Capitalization Equity**

*Measured by the S&P 500. Covers 500 industrial, utility, transportation and financial companies in the U.S. markets. The value-weighted index represents about 75% of NYSE market capitalization.*

**Small and Mid-Capitalization Equity**

*Measured by the S&P 400 Midcap and S&P 600 Smallcap. The S&P 400 Midcap is a capitalization-weighted index measuring the performance of the mid capitalization sector of the U.S. equity market. The S&P 600 Smallcap is a capitalization-weighted index that measures the performance of selected U.S. stocks with small market capitalization. The prices of small and mid-sized company stocks are generally more volatile than large-company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.*

**Growth and Value Investment Styles**

*Measured by companies within the Standard & Poor's 1500 index. This includes the S&P 500, S&P 400 Midcap and S&P 600 Smallcap.*

**International Equities and Emerging Market Equities**

*Measured by MSCI EAFE, MSCI Emerging Markets indexes. The MSCI EAFE (Europe, Australia, Asia and the Far East) represents all of the MSCI developed markets outside of North America. The MSCI Emerging Markets is a float-adjusted market-capitalization index designed to measure equity market performance in global emerging markets.*

**Fixed Income**

*Measured by the 10-year Treasury note, The Barclay's Capital U.S. Government/Credit and the NBBITR and NBBHTR Index. The Barclay's Capital U.S. Government/Credit Index offers market-leading benchmarks and alpha-generating*

index products to meet the diverse needs of global investors including investment and market analysis of both alpha and beta sources, portfolio benchmarking and performance measurement, asset allocation, and the creating of index tracking funds and index-based structured products. Note: All legacy Lehman Brothers benchmark indexes were rebranded as Barclay's Capital Indexes in November 2008. The NBBITR and NBBHTR Indexes are a measure of the average price change of all bonds in the FINRA-Bloomberg Active U.S. Corporate Bond Index weighted by par amount.

**High Yield**

Measured by the Merrill Lynch High Yield Master II Index. This is a measure of the broad high-yield market commonly used as a benchmark for high-yield corporate bonds.

**REITs**

Measured by BBREMTG Index. This is a measure of infinite-life mortgage REITs having a market capitalization of \$15 million or more.

**Commodities**

Measured by the CRB Index, S&P GSCI Index and RICI Index. The CRB Index is a Spot Market Price Index that measures the price movements of 22 sensitive basic commodities. The commodities used are in most cases either raw material or products close to the initial production stage which, as a result of daily trading in fairly large volume of standardization qualities, are particularly sensitive to factors affecting current and future economic forces and conditions. Highly fabricated commodities are not included for two reasons' (1) they embody relatively large fixed costs, causing them to react less quickly to changes in market conditions; and (2) they are less important as price determinants than the more basic commodities, which are used throughout the producing economy. A spot price is a price at which a commodity is selling for immediate delivery. The S&P GSCI Index is diversified among commodities and represents a cross section of the principal raw and semi-finished goods used by producers and consumers. The RICI Index or Rogers International Commodity Index is a composite, U.S. dollar based, total-return index created by James Beeland Rogers Jr. on July 31, 1998. The RICI was designed to meet the need for consistent investing in a broad-based international vehicle. It represents the value of a basket of commodities consumed in the global economy, ranging from agricultural to energy to metal products. The value of this basket is tracked via futures contracts on 36 different exchange-traded physical commodities, quoted in four currencies, listed on eleven exchanges in five countries.

---

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances.

**Additional Information Available Upon Request**

Wells Fargo Advisors is the trade name under which Wells Fargo Corporation provides brokerage services through two registered broker-dealers: Wells Fargo Advisors, LLC, Member SIPC, and Wells Fargo Advisors Financial Network, LLC, Member SIPC. Each broker-dealer is a separate non-bank affiliate of Wells Fargo Corporation.

---

Securities and Insurance Products		
Not Insured by FDIC or Any Federal Government Agency	May Lose Value	Not a Deposit of or Guaranteed by a Bank or Any Bank Affiliate